1 September 2017, 14:50 CET

Interest & Exchange

Back in the Saddle

Global Strategy: In the present low macro volatility environment, geopolitics aside, the two biggest surprises this year are the lack of reaction from core inflation to a fairly robust and synchronized economic recovery, and recent FX movements, mainly the EUR strength. To differing degrees, we think these events could delay even further the gradual exit strategy from the extreme monetary accommodation by the ECB and Fed.

US Macro: After two consecutive quarters of disappointments, GDP came back to above 2.0% SAAR in 2Q17. We expect growth to remain at c2.5% in 2H17, which would be consistent with our estimate of 2.2% for the year as a whole. Although we are not very positive on future private consumption, we do not see downward risks in the very short run. The possible approval of President Trump's fiscal plan could imply some upward risk to our numbers.

US Rates: A number of additional UST-bullish factors have entered the scene in the past few weeks. However, we see the risks for US rates biased towards a bounce back, rather than breaching the lower end of recent ranges. As regards the shape of the curve, the flattening trend could still continue. We like receiving the belly in 1s3s5s 1y forward as a carry-efficient alternative to 2s10s flatteners.

EUR Macro: The economy posted an encouraging performance in 1H17 that we expect to continue in the second half of the year. The consolidation of the upturn in domestic demand and companies' optimistic outlook on exports suggest that the economy is still quite resilient to the appreciation of the euro, although we think it is the main downside risk for activity and inflation.

EUR Rates: Slow global reflation, belief in a more tentative Fed and Euro strength cap ECB policy expectations for September. Current low yields incorporate a lot of bad news but not the Euro area macro recovery. Similarly, spread widening leaves periphery, in particular SPGBs and PGBs, at attractive relative levels.

GBP Macro: The Q2-17 GDP data revealed a marked slowdown in real consumer expenditure growth, to just 0.1% q-o-q, the weakest since Q4-14. Commonly attributed to the impact of rising inflation, we question such rhetoric, as spending also proved weak in nominal terms. Instead, we argue that inflation was more influential during 2013-15, as falling import prices boosted reported consumption growth. Strength of employment growth and credit availability still argue against a sustained downturn in UK consumer expenditure.

GBP Rates: The last month saw low volatility, a continuation of existing themes and little conviction in the UK rates market. Our main scenario is that this ambiguous state continues, allowing the UK to follow other rates higher in coming weeks. However, the unpredictable Brexit process has risks to either side; we discuss two alternative narratives and potential early indicators.

G-10 FX: The USD remains vulnerable amid global risk, domestic political issues and a more 'dovish' Fed. The EUR remains a main beneficiary from the USD sell-off, but the pace of recent gains (EUR/USD above 1.20) suggest that the pair is drifting into overbought territory, at least in terms of the fundamental trade-off between the US and Eurozone. Sterling remains weak against the EUR, amid softer UK economic data and ongoing Brexit uncertainty, but the soft USD should continue to provide GBP/USD with some support into the end of the year.

Antonio Villarroya
Head of Macro and Strategy Research
antvillarroya@gruposantander.com

José María Fernández
Rates Strategist
josemariafernandezl@gruposantander.com

Edgar da Silva
Rates Strategist
efda@gruposantander.com

Antonio Espasa
European Chief Economist
aespasa@gruposantander.com

Beatriz Tejero
Economist
beatriz.tejero@gruposantander.com

Laura Velasco
Economist
laura.velasco@gruposantander.com
Banco Santander, S.A.
(+34) 91 257-2244 / 175 2289

Luca Jellinek
Head of Rates and FX Strategy
luca.jellinek@santandergcb.com

Stuart Green
UK Chief Economist
Stuart.Green@santandergcb.com

Adam Dent
UK Rates Strategist
Adam.Dent@santandergcb.com
Banco Santander, S.A. London Branch
(+44) 20 7756-4111 / 6170 / 6223

Stuart Bennett
G-10 FX Strategist
stuart.bennett@santandergcb.com

Michael Flisher
G10 FX Strategist
michael.flisher@santandergcb.com
Banco Santander, S.A. London Branch
(+44) 20 7756- 4136

For a full list of contributors, please refer to page 37

Santander's Interest Rate and FX Strategy Research in Bloomberg: SRFS <Go>.

Banco Santander, S.A. is registered in Spain and is authorised and regulated by Banco de España, Spain (C.I.F.:A39000013). Banco Santander, S.A. London Branch is registered in the UK (with FRN 136261) and subject to limited regulation by the FCA and PRA. Santander Investment Securities Inc. ("SIS") is a member of FINRA, US (CRD. nº 37216). US recipients should note that this research was produced by a non-member affiliate of SIS. For further disclosures please see the back of this report and our website.

Santander GLOBAL CORPORATE BANKING

#SanMacroStrategyViews: Our main views ... in a Tweet

	USD	EUR	GBP
Economic Outlook	We have revised our estimates for 2017E to 2.2% (vs 2.6% in March) after the poor growth numbers of 1Q17. Public and private consumption and inventories could stop dragging growth	We have revised our estimates for the EZ to 2.0% in 2017 and 2018 (vs previous 1.9% in both). GDP is driven by strong internal demand, with net exports making a negative contribution.	We expect slow growth through end-2017, as Brexit uncertainty weighs on investment and a real income squeeze hits consumers..
Monetary Policy / Front-End	With the Fed focused on its b/s reduction, another hike in 2017 will depend on Core CPI rebounding and/or a sizeable fiscal plan going through.	The strength of the EUR should keep the ECB's tone on the dovish side, but EAPP tapering should start in Jan'18.	We expect Bank Rate to stay at 0.25%, with QE levels unchanged, for the foreseeable future. We expect the 2 MPC votes for higher rates to fade in coming months.
Rates / Duration	Despite largely disregarded by the market right now, some UST-bearish factors remain. We see the risks biased towards a bounce back.	Current pricing reflects global economic downside and central bank inaction, rather than the improving EA fundamentals. Core rates look rich.	We are mildly bearish on UK rates, anticipating upward pressure from busier autumn markets and healthy global macro conditions.
Curve / Slope	The FF and ED curves look too flat. Further out the curve, additional flattening is possible (receive 1s3s5s 1y fwd as a carry-efficient alternative to 2s10s flatteners)	Curve slope in EUR remains strongly positively correlated to direction. The 10y area is slightly rich to the curve, statistically.	2s15s steepeners (1y-forward) are our favoured bearish expression. We expect the US to re-steepen faster than the UK, and still like a 2s5s box there.
Spreads	Increasing funding needs + potential changes in SOMA reinvestments pose a risk for USTs. We like swap spread wideners (bearish on USTs).	Summer-time widening on geopolitical concerns is at odds with improving economies and fiscals. Attractive entry point for periphery overweight.	Gilt spreads are much wider than last summer, and should come under tightening pressure when (govie and corporate) supply resumes.
Volatility	We think implied vols remain low all over the surface. The top-left corner looks particularly cheap vs. delivered, and should be particularly sensitive to any FOMC surprises	Low realised vols and more cautious central bank statements, relative to early summer, implied vols can remain in the lower portion of their recent range.	Implied vols have moved sideways over the summer, and generally seem to under-price the chance of a major Brexit surprise, in either direction.
Inflation / Break-evens	Breakevens remained relatively stable despite the decline in nominal rates, oil and the USD. We continue to see room for further rises in breakevens, particularly in the front end.	Though many investors remain sceptical of inflation acceleration, 10y ILS levels near accruing actual inflation make long-inflation positions cheap to hold.	UK CPI set to peak around 3% in Q3-17, and we forecast a sharper deceleration in H1-18 than the MPC currently expects. Lack of ultra-long linker supply should help long BEs.
FX	USD remains on the back foot as the market prices in political concerns. But a robust economy and further rate hikes should provide some support in Q4-17.	The market is positive the EUR, helped by a weaker USD. But it may have moved too far, too quickly and could already have priced in the 'good' economic and policy outlook.	Sterling has picked up recently, but remains vulnerable. The economy is slowing, we do not expect the MPC to hike rates yet and Brexit remains a risk.
Main Risks (to our views)	Chinese economic sizeable deceleration. EM assets reaction to the Fed's possible initial adjustment, in a structurally more illiquid market.	Even after the French presidential election, political, economic and financial uncertainty remain relatively high, with 'risk' markets priced for a continuation of the positive trend.	A sharper downturn in confidence and further exchange rate weakness. Wages beginning to accelerate. Political gridlock developing in the government or Brexit negotiations.

Source: Santander Economics, Rates and FX Strategy Research. For a full list of contributors, please see contact details on page 37.

Global Strategy: Central Banks' Seasons of Wither

Antonio Villarroya
Head of Macro & Strategy Research
(+34) 91 257-2244

- **In the present low macro volatility environment, geopolitics aside, the two biggest surprises this year are the lack of reaction from core inflation to a fairly robust and synchronized economic recovery, and recent FX movements, mainly the EUR strength.**
- **To differing degrees, we think these events could delay even further the gradual exit strategy from the extreme monetary accommodation by the ECB and Fed.**

Chart 1: Trade Weighted USD weakens .. to its long-term trend

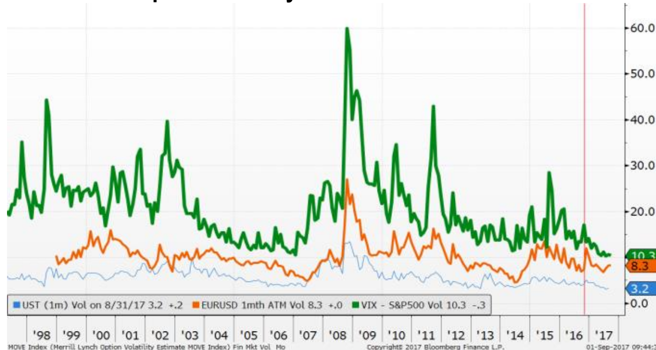
Source: Bloomberg, Santander

Despite the potential risks, given the seasonal decline in market liquidity and stretched valuations in many financial assets, the summer period now ending did not produce any major market shocks – at least none caused by macro or financial events or releases, with the geopolitical environment being the main provider of market scares in recent weeks. However, implied –and delivered– market volatility remains at the lower end of its long-term trend (Chart 2).

This lack of sharp movements in financial markets is supported by the absence of major macroeconomic surprises in either real activity or business surveys in Advanced Economies, partially due to these economies' Central Banks policies. If any, the biggest surprise would be the lack of reaction from consumer price indices to a fairly healthy and prolonged economic recovery.

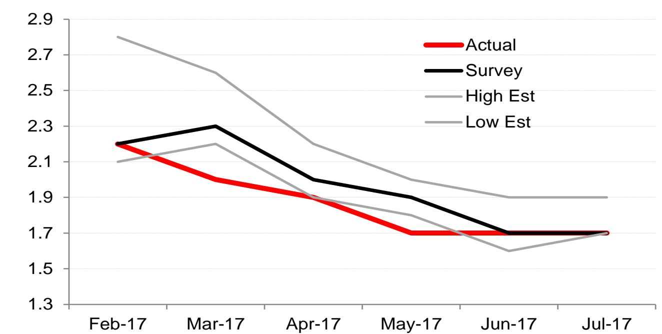
This low inflation environment is, however, proving to be a headache for these economies' monetary authorities, and was recently complicated further by some sharp FX market movements, mainly the EUR strength. In the US, despite the USD decline triggered by the deflation of the initial post-electoral reflation trade, the DXY is still 10% above its 10-year average and as much as 30% above its 2008 and 2011 lows (margin chart).

Chart 2:Financial market volatility; UST, EURUSD and S&P500 one-month implied volatility



Source: Bloomberg, Santander, Central Banks

Chart 3: US Core CPI; recent releases have disappointed clearly on the downside



Source: Bloomberg, Santander

Janie's got a gun … or two

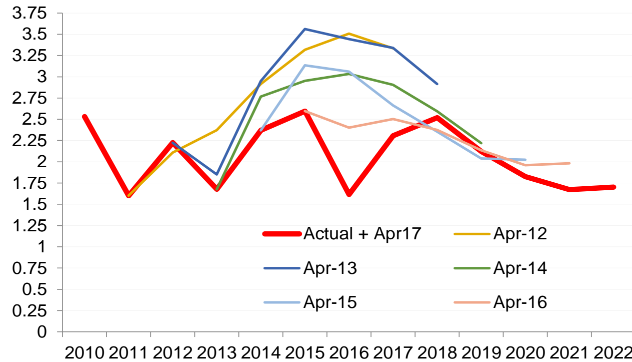
The US's August CPI will be released on 14 September. Focus on the Core measure

In this environment, the main concern for the Federal Reserve regarding its ongoing gradual removal of monetary accommodation is the sequential downward surprises in core inflation despite the very healthy labour market. US Core CPI has not only decelerated from 2.3% in January to 1.7% in July, but all the recent releases have been at the bottom –or even below– the lowest consensus estimates (Chart 3). In this regard, the 10% YTD USD decline should be seen as a mild relief for the Federal Reserve, as it should help both real growth and import prices recover a bit faster than otherwise.

While the jury is still out on whether the relationship between growth and inflation has definitely been broken or whether it is simply a question of lower elasticity and/or a longer lags in their reaction function, and given the uncertainties regarding the upcoming debt ceiling deadline and the lack of clarity regarding the timing and extent of the expected fiscal easing in the US, **the Fed now seems likely to take a pause in its hiking cycle and concentrate on reducing its balance sheet.**

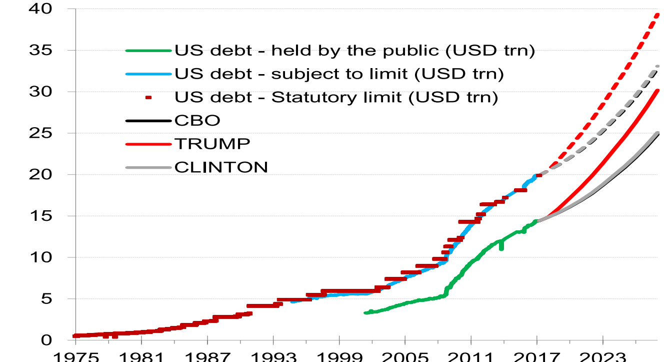
The details on this pending fiscal reform and infrastructure spending plan are relevant not only to assess its possible positive macro impact on US corporate and individual finances, and therefore improving the US's weak long-term growth prospects (Chart 4), but they will also be relevant to assess to what extent this fiscal expansion would be self-financed. As we have discussed in the past, there is a dangerous impact of having to finance the fast growing amount of public debt at increasingly higher rates (Chart 5).

Chart 4: US GDP and (IMF) projections



Source: Bloomberg, Santander , IMF

Chart 5: US Public debt, ceiling, and CBO projections



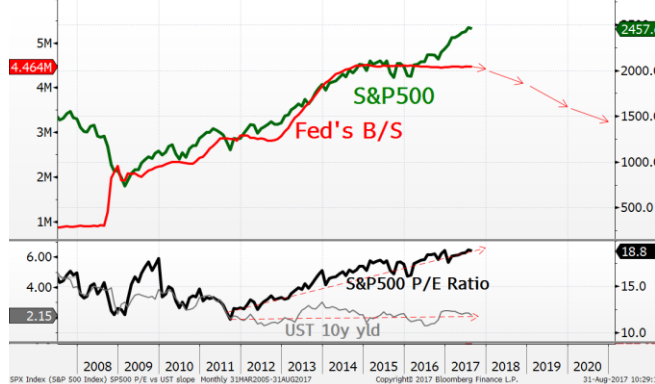
Source: Bloomberg, Santander, CBO

Fed short-term outlook – Living on the edge

*"The Committee is maintaining its policy of reinvesting principal payments … until normalization of the level of the fed funds rate is well under way" **(Dec'16 FOMC)***

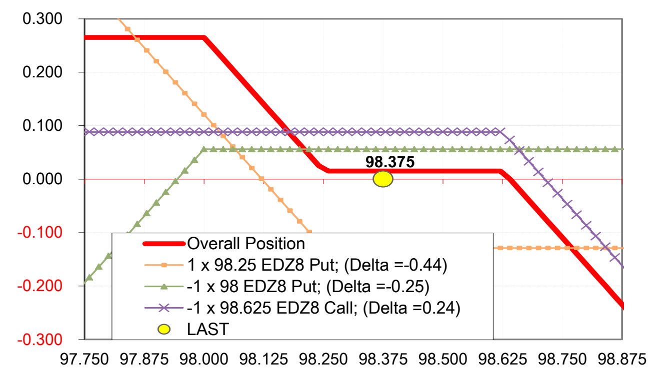
Although we think the Fed would have preferred to take a pause in its hiking cycle with slightly higher rates (see margin), it is likely to skip September in its recent quarterly hiking cycle pattern. Regarding the downsizing of its balance sheet, as we already know the pace of reduction (Chart 6), barring any surprises –and acknowledging some uncertainty on MBS early prepayments– we are only missing the start date of this reduction. **We think its start will be announced at the Sept 20th FOMC**, although it doesn't necessarily have to start immediately (yet it will probably be before year-end).

Chart 6: S&P500 vs Fed'sBalance Sheet + Expected decline



Source: Bloomberg, Santander

Chart 7: EDZ8 98.25-98.00 Put Spread funded w/ 98.625 Call



Source: Bloomberg, Santander

Fed long-term outlook – Walk this way

We think the probability of a Fed hike in Dec'17 has fallen to 30-40% (still above the market), depending on a possible rebound of core inflation and a clearer view of any fiscal easing being … but we see more value in Dec'18 EuroDollar Puts (the Fed would have to cut rates for the trade to lose money)

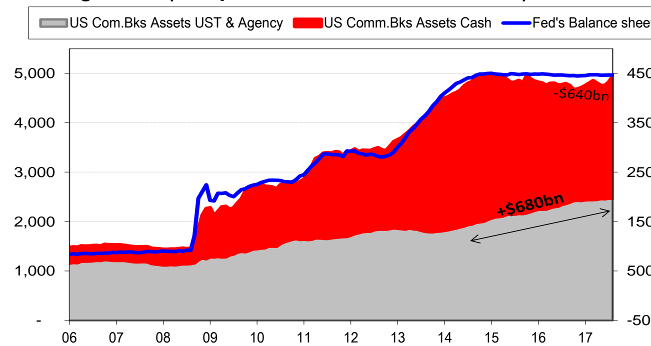
Beyond September, a hike in Dec17 also looks increasingly less likely. Although we have always been quite sceptical of the new US president being able to deliver a significant part of his electoral fiscal promises, the progress so far has been even less than we feared, as we thought at this stage some form of fiscal reform –mostly focused on Corporates and the simplification of the Tax Code– would be under discussion in Congress, with good chances of being passed around year-end. Should this fiscal stimulus fail to take shape in the near future, any 4Q17 hike would depend on core inflation rebounding, helped by the recent USD fall, and the debt ceiling issue being solved promptly. That said, the c.25bp of hikes priced-in by the end of 2018 seem too low to us and **we therefore see value in EDZ8 Put spreads** (such as 98.25-98.00), funded by selling 24-Delta Calls (98.625) to be basically zero-cost (Chart 7).

US long-term rates – Fly away from here

We continue to expect US long-term rates to remain subdued (below its forwards). But, barring any further escalation in the geopolitical environment, we think they should have bottomed out at around current levels. Also, given the current positioning, upward spikes in yields should be more extreme than subsequent yield-grabbing downward movements ("Rockets vs Elevators")

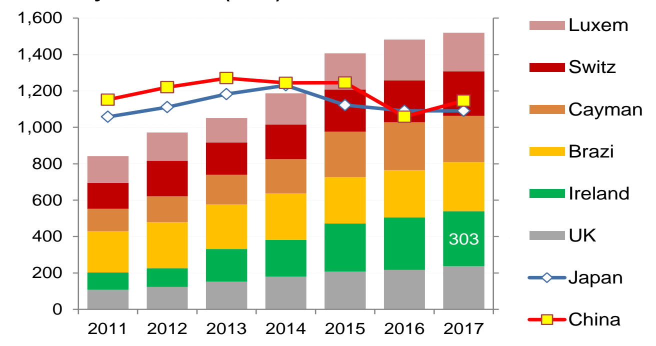
Regarding longer US rates, we do not think the reduction of the Fed's balance sheet will, per se, be a big market mover, as its size will still be above $3trn by the end of 2020. That said, the Fed will now be buying $250bn less USTs in 2018 than otherwise, ie, the Treasury will 'lose' a potential buyer of more than half its 2018 net funding needs. That is one more reason why not only the size but, more importantly, the funding of any potential fiscal impulse becomes key as this possible extra net supply of bonds will have to be met with significant demand to avoid a large increase in US rates / funding costs that could further threaten this country's economic recovery. The focus will therefore be on: (1) **US commercial banks**, which have increased their UST and Agency holdings sizeably (+$680bn in the last four years, Chart 8); and (2) **Foreign investors**. Probably helped by interest rate differentials -and maybe the recent USD weakness-, international investors remain clear net buyers of US government debt assets – with the exception of China, whose purchases are basically proportional to its FX reserves (Chart 9). Japanese investors could become key in this regard with 10y JGBs trading back at c. 0% again.

Chart 8: US Commercial Banks' holdings of Cash and UST+Agencies (compared to Fed's Balance sheet)



Source: Bloomberg, Santander

Chart 9: Recent Evolution in Largest Foreign Holdings of US Treasury Securities ($ bn)



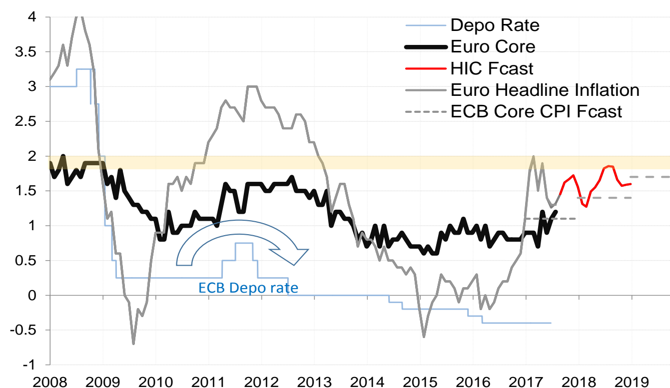
Source: Bloomberg, Santander

Mario's Mandate – Dream on

/

On the other side of the Atlantic, the above-mentioned inverted Philips curves and lack of reaction from consumer prices to a fairly robust macro environment –or from wage settlements to a clearly improved labour market– is even more worrisome for the ECB, mainly because: (1) **Inflation** is its only mandate and, according to its own forecasts, this goal is not being attained (Chart 10), while the Fed is at least fulfilling the labour market aspect of its dual mandate.

Chart 10 :EUR Headline and Core Inflation + ECB forecast



Source: BBG, Santander

Table 1: Euro Effective Exchange Rate (YTD performance vs main partners)

Country	Weight	Last	29-Dec-16	Change YTD	Impact
China	22.3%	7.82	7.28	7.4%	1.6%
US	16.0%	1.188	1.05	13.4%	2.2%
UK	13.1%	0.92	0.86	7.5%	1.0%
Switz.	7.0%	1.14	1.07	6.5%	0.5%
Japan	6.7%	130.9	122.0	7.3%	0.5%
Poland	6.4%	4.25	4.41	-3.7%	-0.2%
Czech R.	5.2%	26.1	27.0	-3.5%	-0.2%
Sweden	4.5%	9.48	9.57	-0.9%	0.0%
S. Korea	4.0%	1335	1264	5.6%	0.2%
Hungary	2.9%	305	311	-1.7%	0.0%
Denmark	2.2%	7.44	7.43	0.1%	0.0%
Romania	2.1%	4.59	4.54	1.1%	0.0%

Source: Bloomberg, ECB, Santander

(2) the substantial **EUR appreciation** complicates the ECB's mandate significantly, even acknowledging its YTD rally is, to a large degree, exogenous. In fact, it is against the GBP and USD (and therefore RMB, given its semi-peg to the USD) that the EUR has appreciated the most (Table 1), comprising the bulk of its YTD effective depreciation.

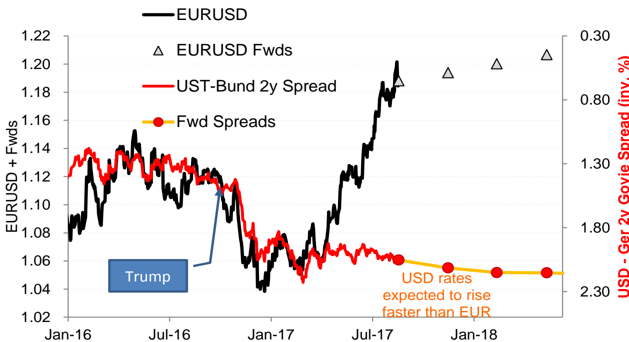
Given its more open status, currency movements are more important for the EUR area in Monetary Conditions Index (MCI) terms than in the US.

And, given the large, mostly political, uncertainties in these two countries in the coming quarters, we doubt the recent trend will reverse completely anytime soon. That said, even having been EUR bulls for many months, we believe the recent movement seems overdone, as the EURUSD correlation to USD-EUR interest rate differentials shows (Chart 11).

EUR Exchange Rate and the ECB – Cryin'

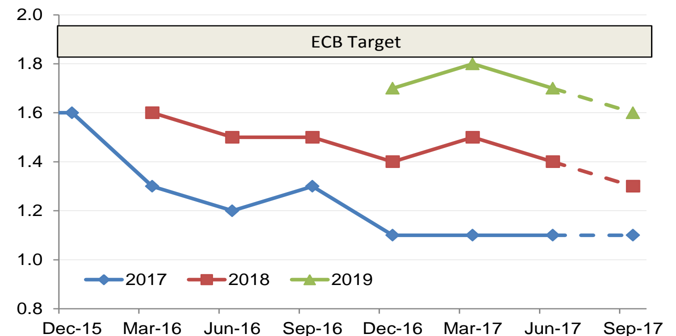
The sharp EUR appreciation creates significant complications for the ECB. When it updates its macro projections on Sept 6th, the ECB is likely to move its forecast for 2019 inflation even further away from its (only) "slightly below 2%" target – despite the strong economic prospects (Chart 12).

Chart 11: EURUSD vs US-EUR interest rate differentials (and forwards)



Source: Bloomberg, Santander

Chart 12: ECB Core inflation projections in its quarterly Staff Macro Projections (+ possible changes in Sep'17)



Source: Bloomberg, ECB, Santander

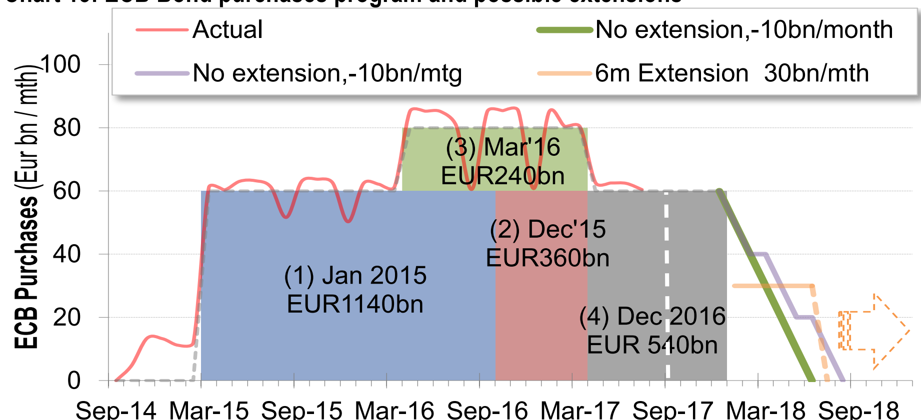
Will FX affect the ECB's exit strategy? – What it takes

*Monetary policy communication in turbulent times, Speech by **Mario Draghi**, 24 April 2014*
https://www.ecb.europa.eu/press/key/date/2014/html/sp140424.en.html

In this environment, and acknowledging that, in the past, the ECB president has argued (see margin) that a continued appreciation of the exchange rate should be addressed through "a further lowering of the interest rate corridor" or "new liquidity injections", we think these measures have already been used to an extreme (€1.7trn in excess liquidity, -40bp Depo rate, etc). Accordingly, **we think the ECB now only has two options: more forward guidance and/or to delay/modify its EAPP tapering plans**.

We still believe the ECB will start reducing the amount of purchases from Jan'18 and also that in the September meeting the GC will debate –but without reaching a conclusion– the timing and speed of the tapering. The only change in our ECB call vs what we expected last December (when the EUR traded at $1.06), is that, rather than a Fed-like progressive tapering of purchases by €10bn/month from Jan'18, as sanctioned at every ECB meeting (as this would seem very hard to reverse if needed), **the ECB might now choose to extend its bond purchases, but for a lower amount** (eg, €30bn/month until June), committing to revisit this decision in 2Q17.

Chart 13: ECB Bond purchases program and possible extensions



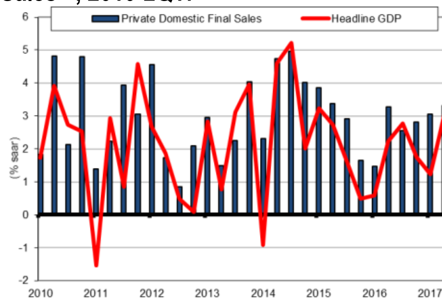
Source: Bloomberg, ECB, Santander

US Economic Outlook

Antonio Espasa
(+34) 91 289 3313

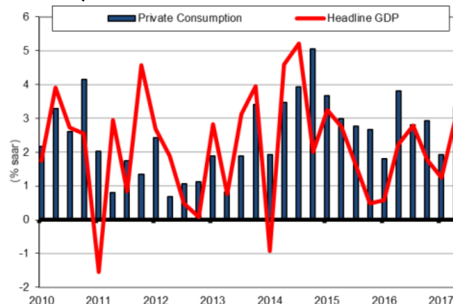
After two consecutive quarters of disappointments, GDP came back to above 2.0% SAAR in 2Q17. We expect growth to remain at c2.5% in 2H17E, which would be consistent with our estimate of 2.2% for the year as a whole. Although we are not very positive on the future performance of private consumption, we do not see downward risks in the very short run. In fact, we maintain our estimates of 2.5% growth in 2017E and 2.7% in 2018E. The possible approval of President Trump's fiscal plan could imply some upward risk to our numbers.

Chart 14: US GDP vs Private Domestic Final Sales– , 2010-2Q17



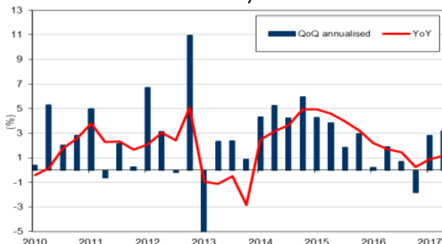
Source: Datastream and Santander.

Chart 15: US – GDP Private Consumption, 2010-2Q17



Source: Datastream and Santander.

Chart 16: US – Real GDI, 2010-Jun17



Source: Datastream and Santander.

GDP growth returned to more than 2.0% SAAR in 2Q17

The release of 2Q17 GDP growth rates confirmed that the economy is not as weak as it seemed in both 4Q16 and 1Q17. GDP grew by 3.0% in 2Q17 vs 1.2% in 1Q17 and 1.8% in 4Q16. Interestingly, the quarterly growth rates in the last three quarters replicated the pattern of previous years. That is, a very weak 4Q and 1Q, with a rebound in quarterly growth rates in 2Q and 3Q. For instance, 4Q15 showed an advance in GDP of just 0.5%, followed by 0.6% in 1Q16 and then 2.2% in 2Q16 and 2.8% in 3Q16. Actually, the effect in 2015-16 was particularly important, since it came along with an adjustment in inventories, which left 2016 GDP growth at a very low 1.5%.

2Q17 GDP numbers showed that the economy is still growing at a relatively good pace, although more slowly than in previous cycles. GDP advanced by 3.0% QoQa in 2Q17, with annual growth at 2.2% (the highest since the 2.4% of 3Q15). According to our estimates, the US economy should maintain quarterly annualised growth of c2.5% in 2H17E. This would leave GDP growth rate at 2.2% for 2017E as a whole, which would imply an improvement from the previous year, but would still be the lowest rate since 2013. All in all, although we believe that the economy has, fundamentally speaking, enough strengths to maintain c2.5% GDP growth rates in the short run, we do not believe it is capable of reaching c3.0% growth rates on a sustainable basis in the near term.

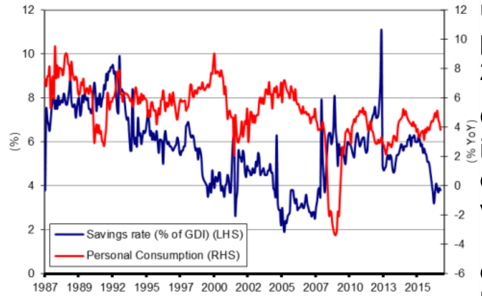
Private consumption maintains a healthy performance in 2Q17 after a weaker-than-expected 1Q17

Private consumption was one of the key supports for GDP growth in 2Q17, with an increase of 3.3% SAAR. This followed a disappointing 1Q17 figure, which came in at 1.9% (the lowest quarterly annualised growth rate since the 1.8% of 1Q16). Consumption of durables (9.0% from -0.1% in 1Q17) and non-durables (4.3% from 1.1% in 1Q17) were the factors behind the rebound, since services actually decelerated to 2.1% in 2Q17 from 2.5% in 1Q17. According to our estimates, private consumption could grow by 2.5% in 2017E and 2.7% in 2018E.

Fundamentals for private consumption are still fine, although it is difficult to justify stronger growth than we have seen so far without an additional improvement in income. Income metrics have actually shown a significant deterioration in their annual growth rates since 2014. Both, personal income and disposable income exceeded 6.0% annual growth in 4Q14. In 4Q16, they were increasing by less than 2.0% YoY, while they are now (June 2017) up by 2.6%. Personal outlays, however, have been growing relatively steadily, at around 4.2% on average, since 2014. Therefore, it is savings that have been closing the gap between the two. The savings rate has fallen significantly in the period. It ended 2014 at 6.1% of GDI and reached 6.3% of GDI in 2015, but it had fallen to 3.8% of GDI by June this year. Actually, the current 3.8% of GDI is higher than the 3.2% of GDI it reached in Dec16.

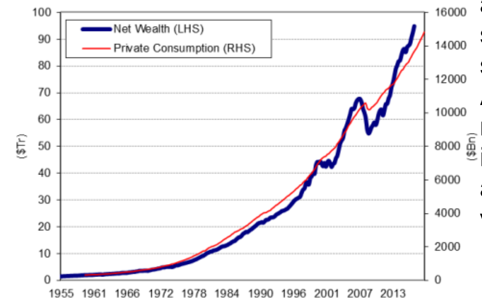
Although in other circumstances the trend and current level of savings could be a matter of concern, the very positive performance seen so far in terms of household wealth metrics clearly overshadows the performance of savings. Net total household wealth is at its highest ever in absolute levels (USD94.8trn) and as a percentage of GDI (6.62% in 1Q17). Given the close relationship between savings and wealth, the very healthy levels of the latter would explain the low level of savings.

Chart 17: US – Savings Rate (% GDI) vs Private Consumption, 1987-Jun17



Source: Datastream and Santander.

Chart 18: US – Households' Net Wealth vs Private Consumption, 1955-1Q17

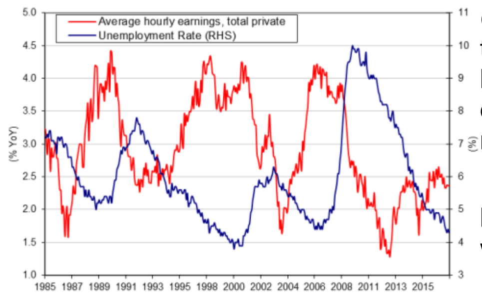


Source: Datastream and Santander.

Chart 19: US – CB Consumer Confidence, 2003-Aug17

Source: Datastream and Santander.

Chart 20: US – Average Hourly Earnings vs Unemployment Rate, 1985-Jul17



Source: Datastream and Santander.

Going forward, and taking into account households' fundamentals, we do not see much scope for growth in private consumption to increase unless housholds start raising their debt levels again, as they did in previous cycles. We therefore remain comfortable with our forecast of 2.5% for private consumption in 2017E and 2.7% in 2018E.

On the positive side, the recent performance of inflation leaves real income metrics in a better situation than a few months ago. Real disposable income grew 0.8% QoQ/1.2% YoY in 2Q17 after showing very modest growth rates in both 4Q16 (-0.5% QoQ, 0.2% YoY) and 1Q17 (0.7% QoQ, 0.9% YoY). Moreover, we do not expect the PCE deflator to return to a level above 2.0% YoY in the very short run, as happened in January and February this year. At current, or even slightly lower levels, prices should represent a relief for real disposable income growth rates in 2H17E.

Consumers are still quite upbeat, which would suggest that the approach to consumption remains at very high levels. August numbers showed that consumer confidence rose again (122.9) to reach its second-highest level since 2000. The present situation index (151.2 in August17) is at its highest since 2001. Income indices and labour market-related indices, like jobs being plentiful, or hard to get, also improved further in the month, which, in our view, is key to justifying additional improvements in consumer confidence and, finally, in our view, in private consumption.

Further improvements in the labour market are key to accelerating personal income growth rates

The key to accelerating personal income growth rates and, as a result, consumption, is probably the labour market. In that regard, the recent performance of the labour market has been relatively positive. Non-farm payrolls have grown by a monthly average of 195k in the last three months, totalling 585k new jobs in that period, which is the strongest employment creation since February. Moreover, most of those jobs were created in the private sector, particularly in services.

We could see a modest acceleration in hours worked in the coming months, which would push growth in the index of aggregate weekly hours back to the 2.0% YoY area. Hourly earnings rose in the last two months (0.2% MoM in June and 0.3% MoM in July), pushing annual growth to 2.4% in July. We would expect some stability in short-term growth in hourly earnings ahead of an acceleration to the 3.0% level in 2018E. As a result, we could probably see a modest acceleration in growth in weekly earnings. Average weekly earnings are up by 2.4% YoY in July, slightly below the levels reached in the last three months (average of 2.6%) but basically in line with the average of 2.3% seen in the last 12 months. The combination of more jobs, an acceleration in hours worked and stability or a slight acceleration in the hourly earnings could mean stronger growth in households' personal income, leading to more consumption.

In summary, we believe that 2H17 GDP growth rates in the US, with the key support of private consumption, are likely to remain around 2.5%, which would be consistent with economic growth of 2.2% in 2017E.

US Rates Strategy: Time for a rebound, again

José María Fernández
(+34) 91 257 2244

- **A number of additional UST-bullish factors have entered the scene in the past few weeks, pushing US rates clearly lower all along the curve. However, despite being largely disregarded by the market right now, there are still risks that have not been cleared and that could push US rates higher. We see the risks biased towards a bounce back, rather than breaching the lower end of recent ranges.**
- **The September FOMC meeting is likely to announce the beginning of the balance-sheet normalization programme (no surprise here), while the updated dot chart should remind us that the FOMC continues to view as appropriate a pace of rate hikes that –even if revised down due to the SOMA reduction and lower expectations of fiscal stimulus– is clearly faster than currently priced in by the market.**
- **As regards the shape of the curve, 2s10s remains highly correlated to macro expectations, and the flattening trend could still continue, just to catch up with recent downgrades in consensus forecasts. We suggest receiving the belly in 1s3s5s 1y forward as a carry-efficient alternative.**

Markets: Too many doubts, too many fears

US rates have continued to trade lower since the previous edition of this report. Back in June we were warning that, all things being equal, it would take a rebound in core inflation to convince the market that the Fed might follow the plans depicted in its dot chart and raise rates significantly faster than priced in by the market.

Table 2: US rates have declined further in the past two months

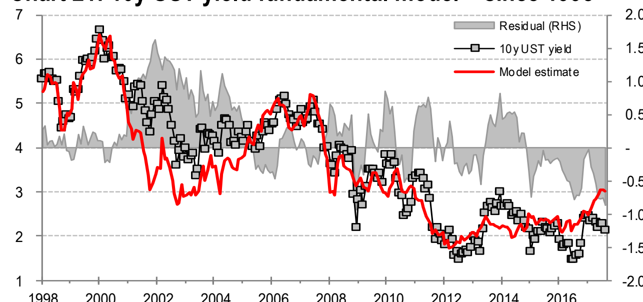
	chg in swap rates (bp)		chg in UST yields (bp)	
	since end-June	YtD	chg since end-June	YtD
2y	**-7**	9	**-5**	14
3y	**-11**	-5	**-11**	-1
5y	**-17**	-19	**-16**	-20
7y	**-19**	-23	**-17**	-27
10y	**-18**	-24	**-16**	-30
30y	**-13**	-19	**-8**	-31

Source: Bloomberg, Santander.

Since then, not only has core inflation failed to show a convincing trend change but also a number of additional UST-bullish factors have entered the scene. Doubts about any significant fiscal stimulus or increase in spending by the new administration have mounted following President Trump's difficulties to pass the healthcare reform and the emerging possibility of a US government shutdown until the debt ceiling is renegotiated. Additionally, the debate about next year's FOMC composition has been influenced by Yellen's speech at Jackson Hole, with some in the market reading her pro-regulation plea as placing herself one step farther away from Trump's position and, hence, making her reappointment in February a bit less likely.

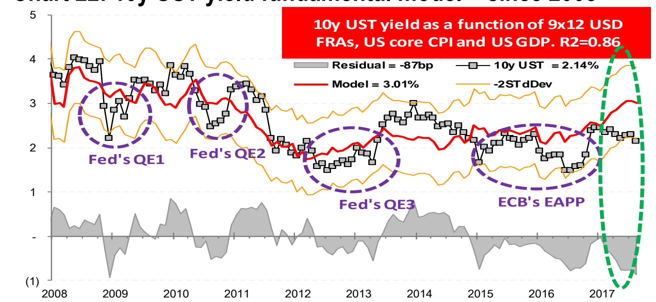
As a result, the market found every reason to maintain its expectations of a more dovish Fed in the months to come, therefore providing a bullish environment for USTs and pushing US rates clearly lower all along the curve (see Table 2). But, here, we see risks to US rates biased towards bouncing back from recent lows rather than breaking year-to-date ranges.

Chart 21: 10y UST yield fundamental model – since 1998



Source: Bloomberg, Santander.

Chart 22: 10y UST yield fundamental model – since 2008



Source: Bloomberg, Santander.

Table 3: Expectations for Fed's UST reinvestments (USD bn)

	Not reinvested in USTs ($ bn/month)	UST redemptions (USD bn)	% of UST redemptions not reinvested
3Q17	-	14.1	0%
4Q17	6.0	45.1	40%
TOTAL 2017	**18.0**	**59.3**	**30%**
1Q18	12.0	110.7	33%
2Q18	18.0	115.8	47%
3Q18	24.0	94.4	76%
4Q18	30.0	97.4	92%
TOTAL 2018	**252.0**	**418.4**	**60%**
1Q19	29.1	87.2	100%
2Q19	30.0	111.9	80%
3Q19	28.9	86.6	100%
4Q19	22.8	68.5	100%
TOTAL 2019	**332.3**	**354.2**	**94%**
1Q20	19.0	57.1	100%
2Q20	22.6	67.7	100%
3Q20	21.3	64.0	100%
4Q20	8.3	24.9	100%
TOTAL 2020	**213.7**	**213.7**	**100%**
1Q21	19.4	58.3	100%
2Q21	22.0	66.0	100%
3Q21	11.3	33.9	100%
4Q21	13.1	39.2	100%
TOTAL 2021	**197.5**	**197.5**	**100%**

Numbers highlighted in red when the UST redemptions scheduled for a given quarter are smaller than the run-off limit.
Source: Bloomberg, Santander.

We continue to find US rates strikingly low compared to what fundamental models would suggest as consistent with the current macro picture (see Chart 22, previous page). While we believe the Fed, and the rest of the major central banks, will remain biased towards remaining on the accommodative side for several quarters (given the lack of inflationary pressures globally), we find it difficult to provide solid grounds for further speculation about significantly lower US rates at this point and, therefore, maintain our call of a gradual upward trend in US rates taking place in the months to come.

Although largely disregarded by the market right now, there are still risks that have not been cleared and that could push US rates higher, including possible changes in the UST supply-demand equilibrium once the Fed stops reinvesting part of its SOMA redemptions (as explained in detail in our 30 June I&E report, the Fed will likely stop reducing its UST reinvestments by $200-300bn in each of the next four years, see Table 3). Also, we believe that the start of the balance-sheet normalization will make the Fed pause the rate hikes for some months, but we will see more of them being delivered in the next few years (even if at a slower pace); this contrasts with current market expectations (see Chart 23). We expect those risks to start weighing on USTs again.

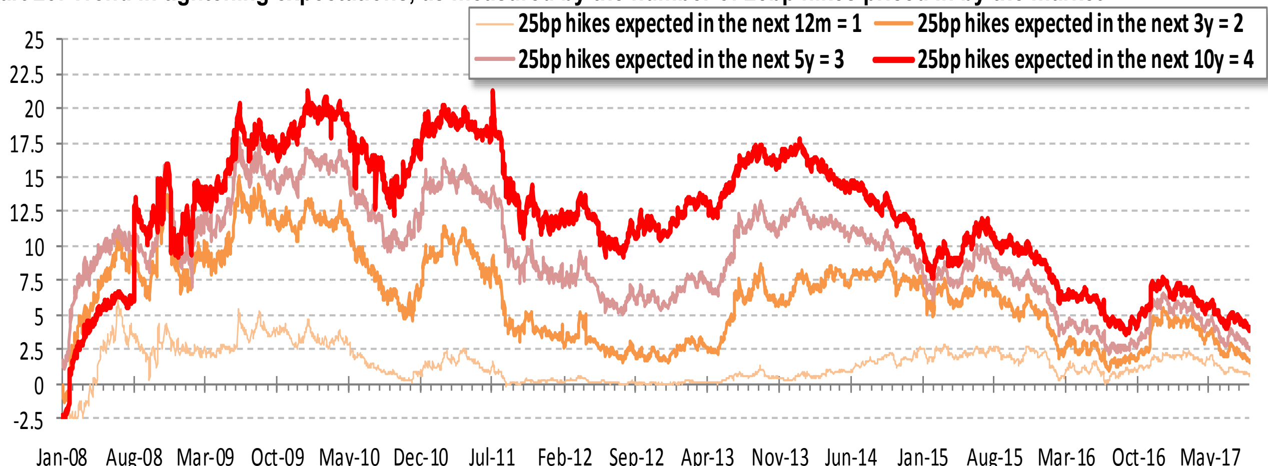
September FOMC: Focusing on the balance-sheet normalization … but are rate hikes over?

In this connection, we believe September's FOMC meeting could be key for the market. The Fed is widely expected to announce the beginning of its balance-sheet normalization programme –something that should come as no surprise at all– and to continue to show the FOMC's intentions to hike official rates significantly faster than priced in by the market.

Starting with the announcement regarding the SOMA reduction, we believe it should have a very limited market impact given that all the relevant information about this programme has already being disclosed (see the *Addendum to the Policy Normalization Principles and Plans*, published by the Fed in June).

The beginning of the balance-sheet normalization should come hand-in-hand with a pause in rate hikes. But, as discussed in our 2 June I&E report, changes in the SOMA portfolio are unlikely to replace all the expected tightening in the US, and official rates could be hiked significantly faster in the next few years than is currently priced in.

Chart 23: Trend in tightening expectations, as measured by the number of 25bp hikes priced in by the market*



* Calculated from the difference between the 1m OIS spot and the 1m OIS forward rates. Source: Bloomberg, Santander.

The dot chart is likely to be revised slightly downwards in September, as some FOMC members could remove expectations of fiscal stimulus and also incorporate the substitutive impact of the balance-sheet shrinkage.

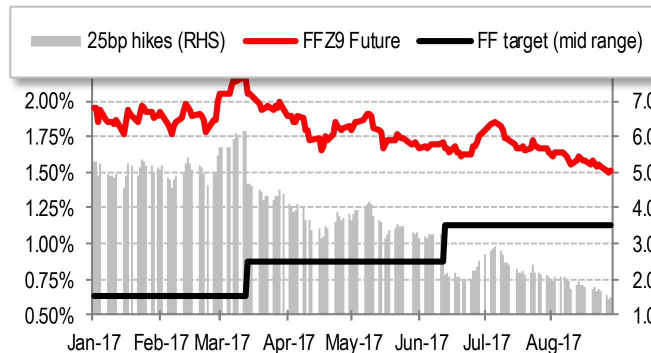
In any event, we expect these dots to remain significantly higher than current market expectations.

That is why the market might be particularly sensitive to the updated 'dot chart' the Summary of Economic Projections (SEP) could unveil in September. Even though the pace of tightening seen as appropriate by the FOMC members might now look slightly slower than in June (as expectations of fiscal stimulus are clearly lower now and there should be no doubt that part of the tightening will be delivered through the balance sheet reduction), it would still comprise several hikes in each of the following years. That should trigger, in our view, some repricing in the US curve, which is pricing in less than two hikes between now and the end of 2019 (see Chart 24).

We would position for such a repricing, playing steepeners in the FF curve. In particular, we see value in the Z8Z9 spread, which currently stands at 12.5bp (i.e., half of a 25bp hike priced in between Dec'18 and Dec'19), while models that have historically succeeded in explaining monetary policy expectations as a function of market conditions suggest that it should trade in the 100bp area. As mentioned before, we expect the Fed to be more cautious now, and part of the rate hikes could be offset by the impact of the balance sheet compression, so we do not expect market expectations to be as high as the model suggests. But the gap between the two of them is so wide now that some steepening seems very likely, and we believe that the spread, currently at year lows, could at least return to its year highs (35bp).

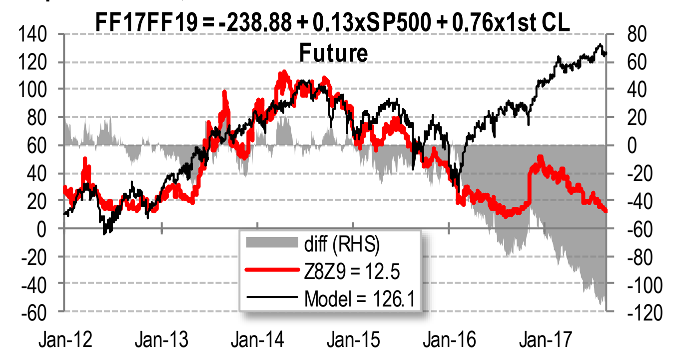
<u>Trade idea:</u> FFZ8Z9 steepeners.
Entry level = 12.5bp. Target level = 35bp. Stop loss = 5bp

Chart 24: Number of 25bp hikes expected between each date and Dec'19



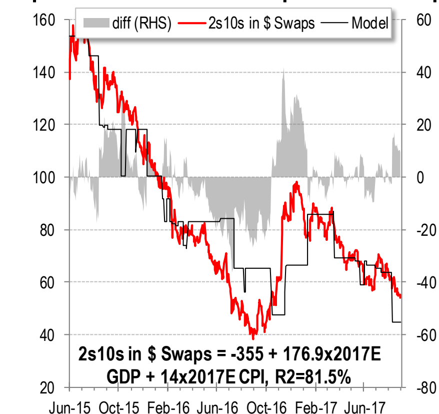
Source: Bloomberg, Santander.

Chart 25: Dec'18-Dec'19 slope in FF futures (bp) vs. SP500 and oil prices model; R2= 81.5% in 2012-2015



* Note that the FF17 and the FF19 contracts currently correspond to the FFZ8 and the FFZ9, respectively. Source: Bloomberg, Santander.

Chart 26: US growth and inflation expectations vs. 2s10s slope in USD swaps



Source: Bloomberg, Santander.

Fundamentals support an even flatter swap curve

Further out the curve, the ongoing downward revisions to macro expectations continue to exert a flattening pressure on US rates, and fundamental models suggest that the flattening trend should continue. As shown in Chart 26, we find statistical evidence of changes in these macro expectations (as measured by consensus estimates for US GDP and CPI) being highly correlated to the 2s10s slope in swaps (R^2=81.5% since June 2015), and recent downward revisions to those forecasts (consensus now stands at 2.1% for 2017 GDP and 2% for 2017 CPI, down from 2.2% and 2.3%, respectively, at the end of June) imply that the fair value of 2s10s should be in the 40-45bp area, 10-15bp flatter than now. Also, if we continue to see downward revisions to CPI figures, for instance, on the back of declining oil prices (the WTI currently trades at 46$/bbl, down from 50$/bbl at the end of July), the model could suggest an even flatter fair value in the USD swap curve.

While the model does not discern between bullish and bearish flattening, we would expect such convergence towards fair value to be driven by the front end of the curve. As explained in the past few pages, as we continue to see rates all along the curve low compared to the current macro situation and monetary policy expectations, from a fundamental perspective the risk of lower rates (and therefore a bullish flattening) should be limited.

Carry-efficient alternatives to 2s10s flatteners in swaps

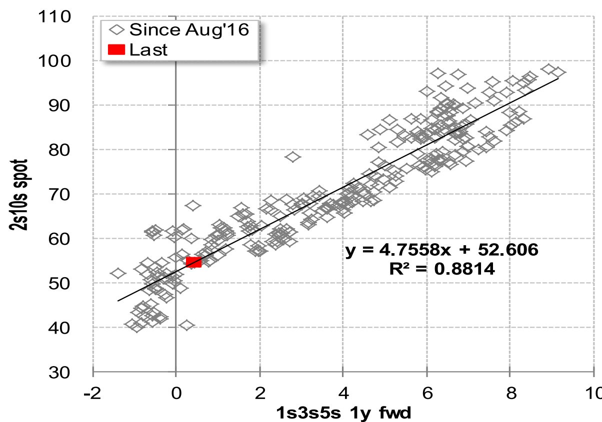
Given that 2s10s flatteners offer a slightly negative carry, we have searched for alternative trades in the USD IRS curve that have historically remained highly correlated to 2s10s (at least during the past 12 months) and that offer a more attractive impact from the time decay.

In table 4 we show the trades that, in beta-adjusted terms, outperform the carry and roll-down of 2s10s flatteners, while maintaining a high correlation (above 90%) in the past 12 months. In particular, receiving the 3y IRS in a fly vs. the 1y and the 5y, 1y forward, should offer a roll-down of around 7bp for the next 3m, once it has been beta-adjusted.

The butterfly factor stands at 0.5bp, and we expect it to decline to -2bp if the 2s10s slope flattens towards the 40bp area (as suggested by the fundamental model). We would stop out if the factor increases to 2bp.

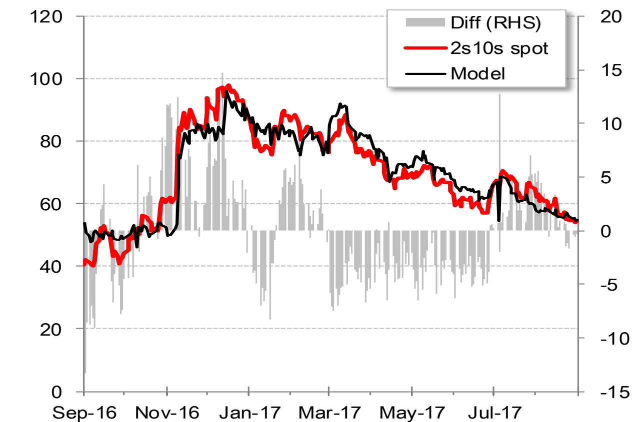
Trade idea: Receive the belly in 1s3s5s, 1y forward.
Entry level = +0.5bp. Target level = -2bp. Stop loss = +2bp

Chart 27: 2y15y USD IRS vs. 7y USD IRS – past 12 months



Source: Bloomberg, Santander.

Chart 28: 2y15y USD IRS vs. 7y USD IRS – model residuals



Source: Bloomberg, Santander.

Table 4: Carry-efficient alternatives to 2s10s steepeners in USD IRS, based on past 12m correlation

Top Alternative Trades by (beta-weighted) C&RD + Regression Residual vs. Bmk Trade

Spot/ Fwd	Trade (USD)	Position	Current (bp)	Correlation	3m Carry (bp)	3m Roll-Down (bp)	3m C&RD (bp)	12m Beta (Bmk vs. Alt Trade)	Beta-weighted 3m C&RD (bp)	FV Benefit vs Bmk Trade (bp)	Beta-Weighted C&RD + FV Benefit (bp)
Spot	SwapSlope:2-10	Short (Flattener)	54.2	1.00	-1.0	0.4	-0.6	1.00	-0.6	0.0	**0.0**
1y	Fly:1-3-5	Long the belly	0.3	0.93	0.0	1.5	1.5	4.77	7.1	-0.3	**7.4**
1y	Fly:2-10-30	Long the belly	12.9	0.98	0.0	0.5	0.5	3.01	1.4	0.8	**2.7**
1y	Fly:2-10-20	Long the belly	14.5	0.93	0.0	0.2	0.2	3.20	0.7	0.8	**2.1**
Spot	Fly:2-5-10	Long the belly	-3.6	0.91	-0.2	0.8	0.7	2.98	2.0	-0.7	**1.9**
Spot	Fly:2-10-30	Long the belly	11.6	0.98	-0.1	0.8	0.7	1.70	1.3	-0.1	**1.7**
6m	Fly:2-10-30	Long the belly	12.3	0.99	0.0	0.2	0.2	2.23	0.5	0.6	**1.7**
1y	Fly:2-5-10	Long the belly	-2.9	0.96	0.0	0.3	0.3	4.93	1.4	-0.3	**1.6**
Spot	Fly:2-10-20	Long the belly	14.2	0.99	-0.2	0.7	0.5	1.84	0.9	-0.1	**1.3**
Spot	Fly:2-5-7	Long the belly	4.7	0.96	-0.3	0.6	0.3	2.98	1.0	-0.5	**1.1**
6m	Fly:2-10-20	Long the belly	14.4	0.98	0.0	-0.1	-0.1	2.45	-0.2	0.6	**1.1**

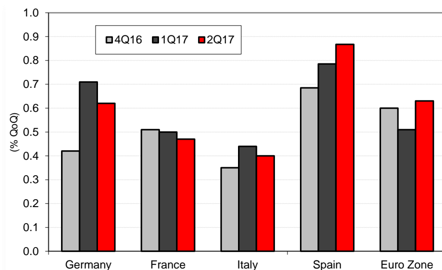
Source: Bloomberg, Santander.

Euro zone Economic Outlook

Laura Velasco
(+34) 91 175 2289

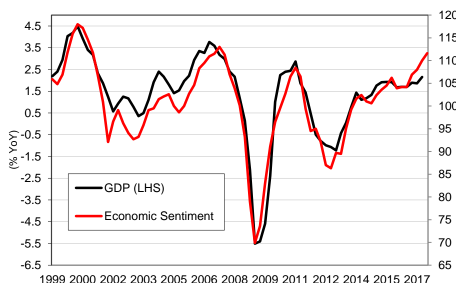
The economy posted an encouraging performance in 1H17 that we expect to continue in the second half of the year. The consolidation of the upturn in domestic demand and companies' optimistic outlook on exports suggest that the economy is still quite resilient to the appreciation of the euro, although we think it is the main downside risk for activity and inflation.

Chart 29: Euro Zone GDP Growth



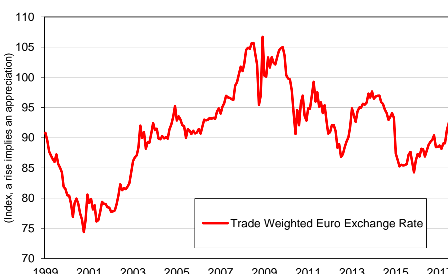
Source: Eurostat and Santander.

Chart 30: Euro Zone GDP and Economic Sentiment



Source: Eurostat, European Commission and Santander.

Chart 31: Nominal Effective Exchange Rate of the Euro



Source: BoE and Santander.

Euro zone GDP performed very well in 1H17, with the leading indicators reinforcing expectations for the continuity of this positive trend in 2H17E. Furthermore, although inflation is contained, it is clearly higher than last year. In this context, the main concern is the potential impact of the euro's appreciation.

Solid GDP growth and composition in 2Q17

The aggregate Euro zone posted GDP growth of 0.6% QoQ and 2.2% YoY in 2Q17, above the 0.5% QoQ and 1.9% YoY seen in 1Q17. Importantly, the economies leading the recovery –Spain and Germany– continue to maintain a very good pace of expansion (and a robust breakdown), while France and Italy are also showing a clear improvement. This points to a synchronized recovery among the major countries in the area.

Spain continues to outstrip the Euro zone average. The economy grew 0.9% QoQ and 3.1% YoY in 2Q17, vs. 0.8% QoQ and 3.0% YoY in 1Q17, driven by a positive contribution of 2.4pp by domestic demand and a net external sector that, in clear contrast with previous recovery cycles, remains in positive territory, adding 0.7pp. In detail, there were solid readings on Private Consumption (0.7% QoQ in 2Q17), Equipment Investment (0.5% QoQ) and Construction Investment (1.1% QoQ) after a strong 1Q17. Exports also increased (0.7% QoQ), supported by the recovery in demand from major trade partners and an improvement in price-competitiveness, with unit labour costs at -0.4% YoY in 2Q17. All in all, the economy is showing a robust diversification between domestic demand and exports. The pace of job creation remains high, and relative prices/costs are under control, which, at the end of the day, means that fundamentals are consistent for another strong performance in 2H17E. Against this background, our GDP forecasts for 2017 and 2018 remain at 3.1% and 3.0%, respectively, with any risk on the upside.

German GDP also maintains a very good pace of expansion. It stood at 0.6% QoQ and 2.1% YoY in 2Q17 (from 0.7% QoQ and 1.9% YoY in 1Q17), crucially supported by final domestic demand, at 0.7pp, with all the main components contributing: Private Consumption, 0.8% QoQ; Public Consumption, 0.6% QoQ; Equipment Investment, 1.2% QoQ; and Construction Investment, 0.9% QoQ. Even Inventories contributed 0.2pp in the quarter vs. -0.7pp in 1Q17. This expansion in domestic demand led to a bigger rebound in Imports (1.7% QoQ) than Exports (0.7% QoQ), resulting in negative (-0.3pp) growth in the net external sector. In short, German households' sentiment is at historical highs, sustained by both employment creation and salary per employee, while companies are posting the sharpest rise in new export orders in seven years. We expect ongoing pressure on capacity and the need to continue investing. Our forecasts for the German economy stand at 2.1% for 2017 and 2.2% for 2018.

Furthermore, **France is consolidating its recovery and even had some positive surprises.** GDP reached 0.5 QoQ and 1.7% YoY in 2Q17 (0.5% QoQ and 1.1% YoY in 1Q17). Net exports made a very positive contribution (+0.8pp vs -0.6pp in 1Q17), thanks to the sharp rebound (3.1% QoQ) in Exports, while Imports rose modestly (0.2% QoQ). However, internal demand had a more modest performance, with domestic final sales up just 0.3% QoQ, probably affected by the uncertainty of the election results. Private Consumption grew by just 0.3% QoQ, and Investments decelerated to 0.5% QoQ. On the other hand, Inventories declined 0.6pp after the 0.7pp added in 1Q17. In our

view, 1H17 numbers, plus the revisions made in previous quarters, point to 2017E GDP growth of more than 1.5%. We believe our 1.6% GDP growth forecast for 2017 could end up being conservative, with the final number being even closer to 2.0%. We estimate 1.8% for 2018, with the risk clearly on the upside (perhaps even slightly above 2.0%).

Italy is also joining the other large Euro zone economies in this growth acceleration process. GDP rose 0.4% QoQ and 1.5% YoY in 2Q17, maintaining the good pace seen in 1Q17 (0.4% QoQ and 1.2% YoY). We believe that both internal demand and the external sector made a positive contribution to GDP growth in the quarter. GDP growth could be closer to 1.5% in 2017E and 2018E, which would imply a significant improvement vs. the performance seen in previous years.

Very good growth expectations for 2H17E

Euro zone GDP growth gained traction in 2Q17 and, in our view, **the recovery in domestic demand clearly improves the area's resilience to euro appreciation** (nominal effective exchange rate +9% since Feb17). In addition, the export numbers through 2Q17 did not evidence any significant declines, and companies remain optimistic.

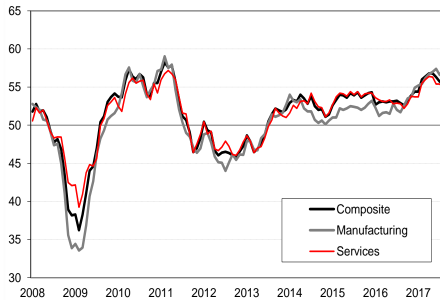
In fact, the confidence surveys suggest that **the Euro zone is still performing very well at the beginning of 2H17E.** The August preliminary Composite PMI stood at 55.8, a sound level resulting from the combination of manufacturing at 57.4 and services at 54.9. Moreover, the report highlights the importance of the sharp increase in exports (fastest rise in six-and-a-half years). Undoubtedly, this supports confidence and production, mainly in the manufacturing sector. In the case of the European Commission's (EC) Economic Sentiment Indicator, in August exports reached their highest reading since Jul07, pointing to more generalized optimism among productive sectors. Furthermore, consumer confidence for August also surprised positively, reaching a level that is 1.9 standard deviations above its historical average. Companies in both manufacturing and services maintain a positive stance on future employment to cope with increasing demand, which should consolidate the recovery in the labour market and, accordingly, support household consumption. In short, we believe that we could see a new acceleration of the economy in 3Q17E.

Inflation in the spotlight because of the euro's appreciation

In this context, Euro zone headline inflation stood at 1.5% YoY in August, below the readings in 1H17, courtesy of the notable reduction in the contribution of the energy component. Conversely, core inflation depicted an uneven trend to end at 1.2% YoY in August, which compares with the lowest rate of 0.7% YoY in March.

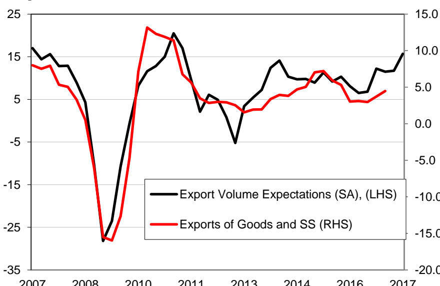
These two opposing inflationary forces could even diverge more in the coming months. On the one hand, **the aforementioned encouraging growth figures are supposed to support core inflation. But, at the same time, the appreciation of the euro makes import prices cheaper.** In this connection, according to the EC (*Quarterly Report on the Euro Area*, Volume 13, October 2014), every 1% of appreciation in the euro's nominal effective exchange rate would lead to a decline of about 0.05pp in the inflation rate over the next four quarters. At the end of the day, the appreciation of the euro can be a strong enough factor to tilt risks for headline inflation forecasts and price expectations to the downside even with core inflation, as we anticipate, maintaining a gradual rise.

Chart 32: Euro Zone PMI Surveys



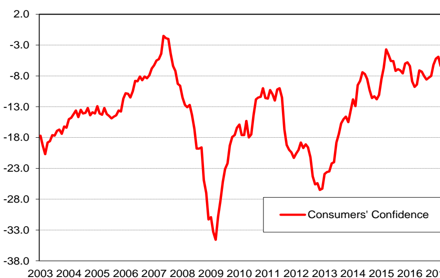
Source: Markit and Santander.

Chart 33: Euro Zone Exports and Expectations



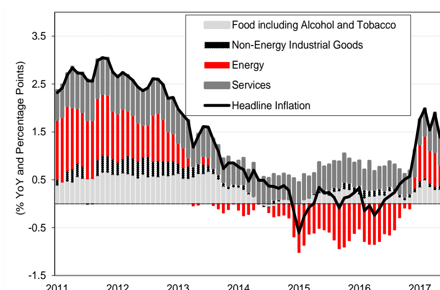
Source: European Commission and Santander.

Chart 34: Euro Zone Households' Sentiment



Source: European Commission and Santander.

Chart 35: Euro Zone CPI



Source: Eurostat and Santander.

Euro Rates Strategy: Central bank constraints and a ‘risk-off’ summer leave rates looking rich and periphery looking cheap

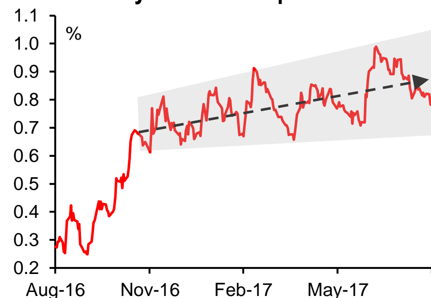
Luca Jellinek
(+44) 20 7756 4111

- **Limited and slow inflation upside, reduced belief in Fed policy normalisation and a strong euro have capped the market’s policy expectations for the ECB in September.**
- **As in late June, current prices incorporate a lot of bad news but very little of the underlying macro recovery. We find current core rates rich.**
- **Similarly, a protracted spread widening move leaves periphery, in particular SPGBs and PGBs, at attractive levels, given solid economic and fiscal performance.**

Shallow directional trend calls fundamentals into question

In the two-month period from late June to late August, EUR rates underwent a sharp but brief rise / sell-off, followed by a shallower but more protracted drop / rally. Such price action conforms to a pattern that has been in place since the end of last year (Chart 36). In the near absence of a trend, it is worth re-examining the key directional determinants, going into the last few months of 2017. Specifically, we look at: inflation dynamics and perceptions; ECB policy developments; flows and valuation.

Chart 36: 10y Euribor swap rate



Source: Bloomberg, Santander

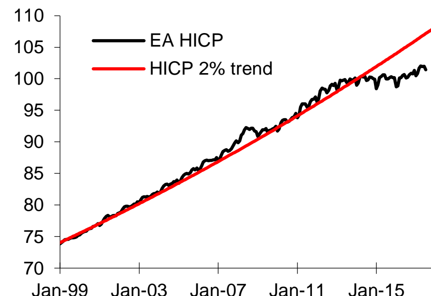
1) Inflation scepticism remains a rates-bullish factor, for now

Medium-term **market and ECB inflation expectations have made very limited progress towards reaching 2%**. That was a key factor in capping the rise in nominal rates. Over the first half of the year, core HICP inflation has been essentially stable to slightly higher (but still below 1.5%) while headline HICP actually slowed in H1 ‘17. This influences market pricing directly but also through the belief that, with inflation at current levels, the ECB cannot really begin to unwind policy accommodation.

Rates bulls can point to the **recent deceleration in inflation in the euro area’s main trading partners and the euro’s strength**. With per-capita output levels and employment still well below pre-crisis trends, the possibility that output gaps are underestimated seems a very real one.

That said, historical precursors of inflation dynamics, including the unemployment rate, capacity utilisation and credit impulse suggest that **core HICP, at least, should continue to creep higher** in the latter part of this year. Similarly, historically reliable determinants of market-implied inflation levels tend also point to higher levels, with the exception of the backward looking (but statistically significant) past inflation average. Oil, for now, is broadly neutral. In such a context, we think it is significant that the 10y inflation-linked swap (ILS), although several bp below its early-August highs, has not corrected sharply.

Chart 37: Prices show no sign of heading back toward a 2% trend



Source: Eurostat, Santander

2) The ECB is still some way from clearly signalling normalisation

Unlike in 2014, from 2015 to very recently, the ECB has said very little about euro exchange rates. The account of the July meeting, however, showed that concern was expressed within the Governing Council (GC). Given also the inflation considerations outlined above, **with the HICP diverging from the 1999-TD 2% trend** (Chart 37), **we agree with the market perception that the euro places a further limit on ECB action.** This is especially true if the Fed, in light of nominal GDP growth topping out and fiscal loosening yet to be delivered, decides to decelerate the pace of monetary policy normalisation.

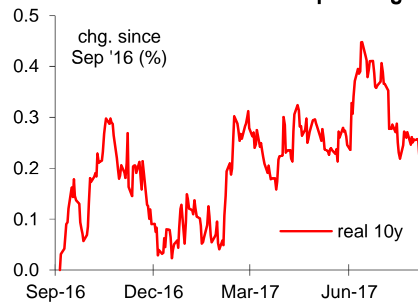
A countervailing 'hawkish' hypothesis for the ECB, promoted by the 'Bundesbank' faction within the GC, is that, with deflation essentially avoided and output / employment looking fine, the ECB does not need to respond linearly to inflation and should start to normalise in 2018. We believe that **the more cautious stance will prevail at the CG policy meeting of 7 September**.

We can expect a small (0.1%) downward tweak in some of the HICP staff forecasts, offset only partially by a similar upward revision in GDP forecasts. The **'forward guidance' language is likely to be unchanged** in terms of macro risk balances, QE or the need for accommodation. On the other hand, either in the Q&A and/or the subsequent account (due out on 5 October), the ECB is **likely to give some indication that the discussion about how to modify QE post its December deadline date has begun**, as well as perhaps some decision triggers in terms of inflation (but no hard HICP figures or euro levels to avoid tying themselves down).

A cautious ECB, in a context of equally cautious central banks elsewhere, **is net bullish for euro area government bonds** (EGBs) and other EUR rates markets.

3) <u>Price action and valuations look tactically overextended</u>

Chart 38: Real rates over 20 bp off highs



Source: Bloomberg, Santander

At the time of writing, the 10y Euribor swap rate had retraced more than 70% of the 22 Jun - 6 July sell-off. This 'saw-tooth' pattern has several precedents. What is more striking than the overall price action in nominal rates is the relatively sharper correction in the 'real' swap rate (IRs minus ILS; Chart 38). This is within a broader context, over the past several years of market-traded inflation more or less tracking likely inflation outcomes but real rates (arguably due to various QE programmes) dissociating from real output growth expectations.

Another way of looking at that is to say that the market continues to discount that central banks like the Fed and ECB *(not to mention the BoJ), will allow policy rates to lag any eventual reflation. The Fed, for instance, is now priced not to hike again until late 2018-early 2019. Even if it gives precedence to balance sheet reduction in the near future, that sort of discount looks optimistic (more details in the US rates section).

Bottom line: duration risk should be reduced at current levels

Scepticism about reflation is understandable, on recent evidence. Nonetheless, the balance of risk is more to the upside, Net of energy prices. The three pillars of ultra-low rates (low nominal GDP expectations, QE policy and lower real policy rates) are being removed only very, very gradually.

Specifically, caution on the ECB's part, is quite likely. However, that does not invert a bias towards eventually reducing the degree of accommodation. The current rates levels suggest that pricing is overstretched.

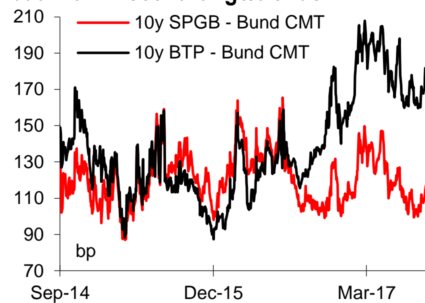
Thus, we are once again in a position where duration should be reduced but also one where paying fixed nominal against floating incurs a high carry cost, relative to the shallow bearish trend. We think that rates investors should consider the following:

- Although real rates are more 'extreme' than ILS levels, we recently re-stated the recommendation to be long inflation (paying fixed) in ILS or breakevens, since that should prove a pretty carry-neutral position (16 August).

- Principal component analysis of EUR rates over 2015-17 suggests that, relative to average dynamics, the curve is too flat, with both the 5y and 5f5y buckets looking rather expensive. On a more compressed time-scale, considering directional relationships vs. curve barbells, the result is fairly similar. Namely**, the 10y spot rate and 5f5y rate are optimal areas for a tactical short position**.

Tactical underperformance by periphery EGBs is an attractive opportunity in our opinion

Chart 39: 10y periphery-Bund spreads wider but within recent range/trends

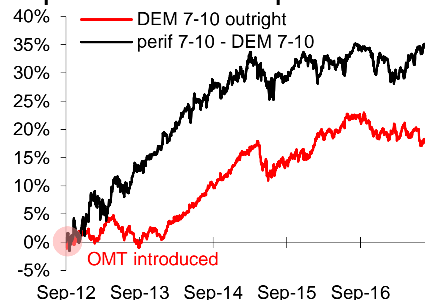


Source: Bloomberg, Santander

Over the past month, **the yield premium paid by 'periphery'** and other Euro area government bonds (EGB s) over German Bunds **has widened again**. Looking at the two largest periphery sovereign issuers, Italy and Spain, in the benchmark 10y maturity, relative spread lows were set on August 1 and, since then BTPs have underperformed by 25 bp, while SPGBs have trailed by 20 bp. While that sort of move is fairly substantive, we would **consider it within the context of broader sovereign spread price action** (Chart 39). Since the beginning of the PSPP, the 10y BTP-Bund spread has gradually widened from a 90-110 bp range to a 160-200 bp range. Over the same period, the 10y SPGB-Bund spread has traded mostly within a wide (90-165 bp) but essentially sideways range. In neither case, does the recent spread move look like it contradicts preceding dynamics.

It is also worth noting that, in terms of underlying yields, **the volatility has largely originated from (falling) Bund yields**, with periphery yields essentially trading sideways. As mentioned in preceding paragraphs, the Bund rally is partly linked to a reappraisal of macroeconomic and monetary policy prospects and, in our opinion, is a salutary reminder of the fact that, despite very minor deviations from strict 'capital key' weights, the PSPP on the whole is more Bund-friendly than periphery EGB-friendly. On top of that, some of the 'risk-off' effect might be related to general geo-political friction with North Korea as well as more specific policy perceptions.

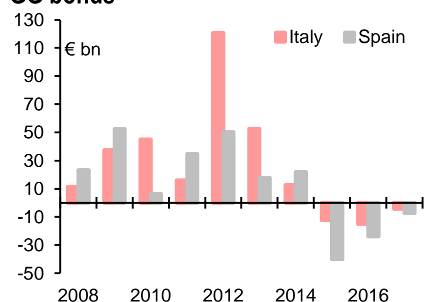
Chart 40: Periphery overweight has greatly outperformed duration exposure



Source: Bloomberg, Santander

In light of a substantive but not game-changing widening in periphery EGBs, **we view current pricing as an attractive near-term entry point** for investors that, for whatever reasons, either are not currently substantially long periphery or reduced their positions before summer. Overall, **the fundamental position of periphery sovereign issuers continues to improve**, although at varying speeds, as we detail further below. Our recommendation has long been for strategically (i.e. continuous) over-weighting of periphery EGBs, in particular SPGBs, within euro area rates portfolios. It is a strategy that has continued to pay (Chart 40).

Chart 41: Bank buying/selling of domestic GG bonds



Source: BoI, BoS, Santander

Flows dynamics continue to be rather heavier for Italy than for comparable sovereign issuers

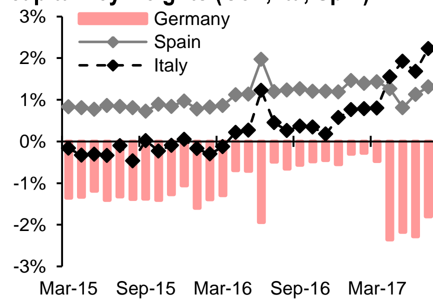
Aside from the usual ebb and flow of primary market supply, two flow-related topics are likely to continue to draw attention in the periphery EGB market: the **domestic bank investment choices and deviations in the PSPP from the capital-key-based allocation of purchases**.

Some interest was generated by the fact that in May and June Italian banks reduced their holdings of domestic government debt by a hefty €29bn. The high level of domestic government bond holdings by periphery banks is a source of potential financial fragility. So, any reduction in holdings, especially if it is balanced by buying elsewhere (in this case PSPP), is perceived as broadly positive.

However, flow data is quite noisy and it makes more sense to look at

longer periods. In the year to July, Italian banks' domestic government bond holdings have shrunk by just € 4 bn. The comparable sum is over €7bn in Spain. It would be more useful to simply say that in both jurisdictions, domestic government debt holdings are large, as a ratio of total assets and of equity capital. In light of the long-term plan to introduce capital weightings for EGBs that more closely reflect credit ratings, **the process of bank divestment from local govies is likely to continue**, especially as long as PSPP provides a ready buyer, but we do not see it as a spread-positive factor.

Chart 42: Deviation of PSPP buying from capital key weights (Ger., Ita, Spn.)



Source: ECB, Santander

In the April to July period, **the degree of divergence between the breakdown by country in PSPP buying and the capital key weights more than doubled** (Chart 42). This might be meaningful both from a monetary policy conduct as well as from a sovereign spreads standpoint. It is worth noting that, before that period, the only departure from cap weights of similar magnitude took place in the wake of the market reaction to Britain's original referendum vote to leave the EU.

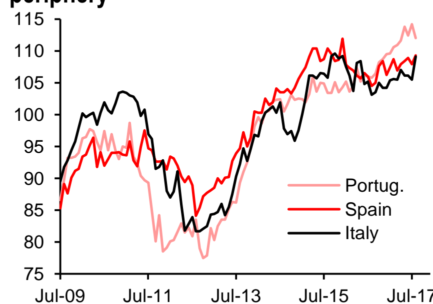
Some investors think that the ECB might extend and/or skew PSPP action to further tighten spreads. We would advise some caution. **Cumulatively**, over 29 months of buying, **the overall 'excess' buying of SPGBs has been merely 0.6% and for BTPs 0.4%. That translates into €9bn and €6bn, respectively, of extra buying**, which is a drop in the ocean compared with gross supply. **This impact to date should not be overstated** unless, contrary to our expectations, the divergence grows substantially.

In terms of primary market activity, after the usual August lull, Italian rolling supply will continue to mount as 2017 supply is expected to be roughly €40bn heavier than in 2015 and 2016. This is not a new development but, nonetheless, **Italian supply will be heavy in absolute terms and relative to GDP, compared with the other main EGB issuers**. For instance, from September to December, Italian supply should be equivalent just under 5½% of GDP (about €90bn in total), while for Spain gross supply to year-end will be just a bit over 3½% of GDP and less than half the Italian amount in outright terms. The equivalent amount for Portugal should be 2-2½% of GDP.

That is in gross terms. Looking at redemptions, Italy has substantial ones in most months but, having experienced particularly large ones in August (over €30bn) with very limited supply, in September and October the balance is more 'regular'. From a flows perspective, fundamentals suggest continued pressure, all else being equal, on the BTP-SPGB spread.

A general improvement in economic data, despite political gridlock

Chart 43: Robust economic sentiment in the periphery



Source: EC, Santander

Economic sentiment indicators and hard data show that the Euro area recovery is increasingly being felt among periphery economies as well as the core. Although periphery economies still have substantial lost ground to regain, at least the trajectory is steadily positive which, both fiscally and politically, should be supportive for sovereign risk valuations.

At +1.5%, Italian y/y real GDP growth is back at levels last seen before the double-dip of 2011-12. The recovery has been slower and more protracted than in other periphery economies but the trajectory looks good and has generated some optimistic commentary. Employment growth in the first half of the year has also been fairly impressive, close to 0.7% of population, at an annualised rate.

Spanish real GDP has been growing at about 3% y/y for the past couple of years (+3.1%, as at Q2), one of the best Euro area performances.

Founded on a broad set of positive factors, including revenue-funded consumption growth, this trend has solid underpinnings.

Portugal's real GDP growth rate in Q2 remained at 2.8% y/y, which is the best pace since 2007 and well above the more modest average set in 2014-2016.

Whereas economic recovery is reflected by the solid approval ratings for the leading, centre-left government party in Portugal, the PS, **in both Italy and Spain opinion polls still point to very fragmented voting intentions**.

Italy's 'caretaker' government headed by PM Gentiloni is now generally expected to remain in place until the spring of 2018, when the normal parliamentary term ends and elections will have to be called (by 20 May). Despite a very split parliament, the government has been able to legislate more actively than had been initially anticipated, partly through liberal recourse to 'confidence votes'. As things stand, **politics remain a potential liability** for investor sentiment, given the poor prospects for an outright majority in Parliament being achieved at the elections. However, there is **no immediate make-or-break situation to focus on**.

In Spain, the coalition government led by the PP has been able to conduct day-to-day business but appears limited in the scope of new legislation it can promulgate. That said, opposition is sufficiently split that the assumption in the market is that the current executive will continue for the foreseeable future. In terms of investor interest and questions, the current focus is the Catalan question, with an independence referendum, scheduled for 1 October, strongly opposed by the central government. While this issue remains of interest to investors, in terms of past reactions we note that the independence referendum held on 9 November 2014 was not associated with any noticeable increase in the volatility of SPGB-Bund spreads.

Away from the periphery countries themselves, the **German vote on 24 September** will be of interest. It seems quite difficult to predict any outcome outside investors' comfort zone, whether it is a CDU-SPD or other coalition of mainstream parties. There has been a lot of talk, since Macron won in France, about 'completing' EMU and efforts to that end should start before year-end. However, it remains to be seen how much mutualisation Germany (and other low-debt participants) are willing to exchange for acceptance of reduced fiscal sovereignty on the part of France, Italy and Spain.

In terms of September's sovereign ratings schedule, Portugal is due for review by Moody's (Ba1 / stable) on 1 September and S&P (BB+ / stable) on 15 September. Following Fitch's decision to change the outlook from 'stable' to 'positive' in June, it is possible that other agencies will follow suit, given a solid fiscal performance there. Spain is due for review by S&P (BBB+ / positive) on 29 September. The shift to a 'positive' outlook by S&P took place **so it is probably early for an upgrade but that is where Spain's rating is arguably heading**, on current trend.

Overall, the political and macroeconomic picture does not suggest any obvious differentiation between the periphery issuers, in terms of fresh news. There are pros and cons in each case, but not to the extent that we would expect intra-periphery spreads to set new ranges. It is worth mentioning that, if we are correct about spreads in general performing well over the next 1-2 months, Italy and, especially, Portugal, often show a higher beta in such circumstances.

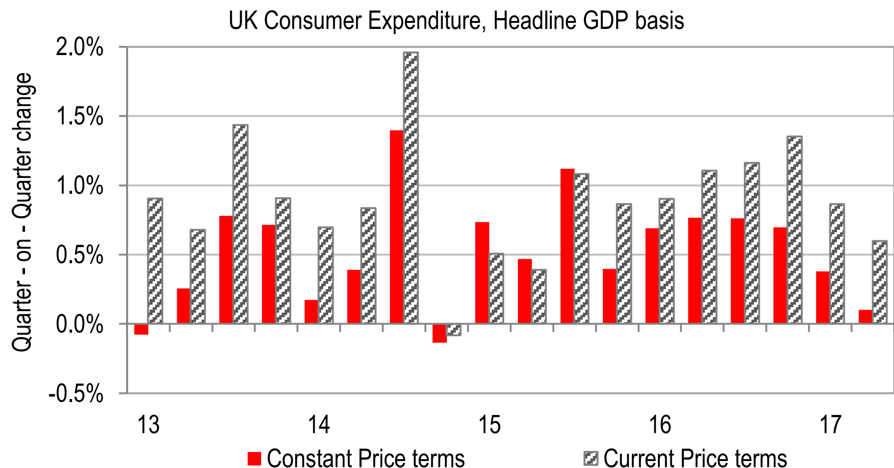
Stuart Green
(+44) 207 756 6170

- **The Q2-17 GDP data revealed a marked slowdown in real consumer expenditure growth, to just 0.1% q-o-q, the weakest since Q4-14**
- **Commonly attributed to the impact of rising inflation, we question such rhetoric, as spending also proved weak in nominal terms**
- **Instead, we argue that inflation was more influential during 2013-15, as falling import prices boosted reported consumption growth**
- **Strength of employment growth and credit availability still argue against a sustained downturn in UK consumer expenditure**

Beware the fable of a UK consumer 'boom and bust'

News of a meagre 0.1% quarterly gain in real terms consumer expenditure during Q2-17 – the weakest for almost three years – has aggravated concerns around the vulnerability of the UK economy to any further slowing of household spending growth. Certainly, with business investment expenditure flat-lining and manufacturing output largely stagnant, the response of households to a continued squeeze in real income growth would still appear central to the UK economy's prospects during 2017E and beyond. On face value, therefore, the initial expenditure breakdown of Q2-17 GDP growth would appear to support concerns that rising inflation could now lead to a consumer 'bust', following on from the apparent consumption 'boom' that had previously propelled the post-2013 upturn in the UK economy.

Chart 44: The slowdown in UK consumer expenditure has occurred in both real and nominal terms, questioning the impact of inflation on consumer spending plans



Source: ONS, Thomson Reuters Datastream, Santander.

However, based on the analysis contained in this note, we believe that a tale of 'boom and bust' would offer a misleading description of UK consumer activity in recent years, and the role of inflation within it. Consumer sentiment certainly appears pressured. But, in our view, inflation offers only a partial explanation of slowdown observed in consumer spending since the turn of the year.

For any given level of nominal expenditure growth, a higher inflation rate will, of course, reduce the reported rate of real terms increase, as was the case with the Q2-17 GDP data. With UK consumer price inflation widely expected to accelerate towards a 3% pace by Q4-17 (after a temporary hiatus in June and July), we believe that some further squeeze on real spending growth is still to emerge, before this process reverses in H1-18 as headline inflation begins to decline. But we see little reason to expect nominal consumer expenditure growth to slow in response to rising inflation, particularly when employment

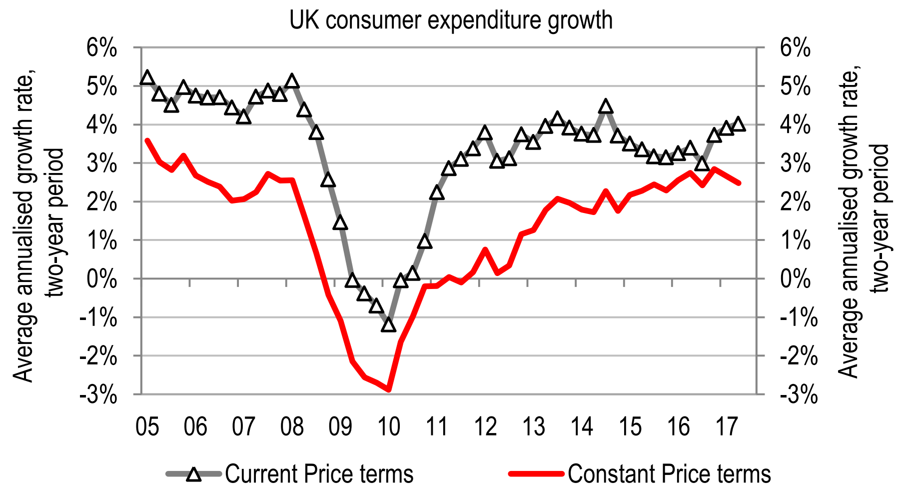
growth remains at a robust level. As such, we view the further moderation of nominal spending growth recorded in Q2-17 – to 0.6% q-o-q from a 0.9% pace q-o-q in Q1-17 – as perhaps the greatest surprise within the detail of the Q2 GDP release, and argue that attributing this slowdown in spending growth to rising inflation risks presenting an over-simplified view of recent consumer behaviour.

Nominal, real terms data offer different views of history

Rather, we believe that the greatest influence of price trends upon reported consumer expenditure growth occurred between 2013 and 2015. In particular, we argue that the apparent acceleration of UK consumer expenditure during this period – when presented in the conventional, real terms GDP basis - owes much to the previous deflationary trends within the prices of the most import-sensitive areas of household spending. This process, which we believe essentially 'flattered' the headline consumption data, has now reversed. In contrast, nominal expenditure growth – which we see as more representative of underlying consumer behaviour and spending decisions, given that many of the determinants of consumer spending (wages, credit growth) are typically assessed in nominal terms – remained largely stable between 2012-16, again questioning the frequent suggestions of an 'over-extended' UK consumer.

Chart 45, which details the average, annualised growth rate over a two year period for both nominal and real terms consumer expenditure (to smooth the volatile series), shows the two series to have been on differing trajectories since mid-2013, as the stability of nominal spending growth contrasted with the apparent real terms acceleration. As such, Chart 45 provides a high level example of the importance of the previous disinflationary trends to the apparent strength of real terms household consumption growth and, by extension, the potential vulnerability of the reported, headline real terms UK growth data should, as expected, inflation resume its climb in the final months of 2017. But, as stated above, although having recently slowed, we see little reason to expect nominal spending growth to turn negative – as was the case in 2009-10 – given the still-supportive labour market trends. In turn, we believe that concerns around a UK consumer 'boom and bust' will ultimately prove misplaced.

Chart 45: The acceleration in real term consumer expenditure growth from 2012 onwards was driven by weaker inflation, and not by stronger nominal spending

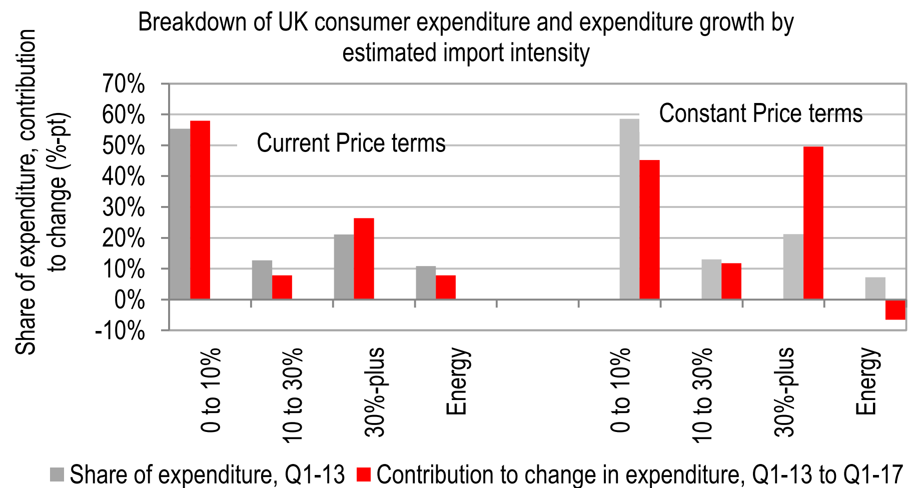


Source: ONS, Thomson Reuters Datastream, Santander.
Note: Chart shows average, annualised growth rate returned over a rolling two-year period within nominal (current price) and real terms (constant price) household consumption expenditure.

Ranking the consumer expenditure data by import-intensity

In order to conduct our analysis, we have produced special series/aggregates of household consumption in both current and constant price terms, ranked by the estimated import intensity of the various goods and services featured within consumer expenditure overall. In terms of classification, we have a created series containing the goods and services within the consumption data with an estimated direct import intensity of between 0 and 10% - reflecting essentially domestic production – and then categories for estimated import intensities of 10 to 30%, and finally 30%-plus. Consumer spending on energy goods is also highlighted, but expenditure on tourism is excluded. As a whole, the data presented in our analysis account for roughly 95% of the headline, household expenditure GDP figure.

Chart 46: On a nominal basis, most growth has come from low import-intensive areas of spending



Source: ONS, Thomson Reuters Datastream, Santander.
Note: Chart shows breakdown of UK consumer expenditure by estimated direct import intensity in Q1 2013, and the contribution of each category to the growth recorded between Q1 2013 and Q1 2017. Data presented in both current and constant price terms.

Using both nominal/current price and real/constant price household consumption data from the past five years, Chart 46 highlights the breakdown of household spending at the beginning of 2013 – again ranked by the estimated import intensity – and the contribution made by each of these categories to the growth in spending observed between Q1-13 and Q1-17.

First, when presented in nominal/current price terms, the contributions made by the various categories to the growth in consumer spending between Q1-13 and Q1-17 have proved largely proportionate to their original share of expenditure. The 0 to 10% import intensity category provided a slightly, disproportionately large contribution to expenditure growth, as did the 30-plus category, with the opposite being the case for the energy goods and 10 to 30% category. But, as a whole, little change appears to have occurred within underlying consumer behaviour.

Real terms growth has been driven by the most import-sensitive areas of consumer expenditure

However, when presented in real/constant price terms, a much more distinct concentration of consumer spending growth is apparent, with something of a polarisation having occurred between the least and most import intensive areas of the expenditure data. In Q1-13, those goods and services with an estimated direct import intensity of between 0 to 10% accounted for 59% of household expenditure (ex. tourism), while those goods and services with an estimated

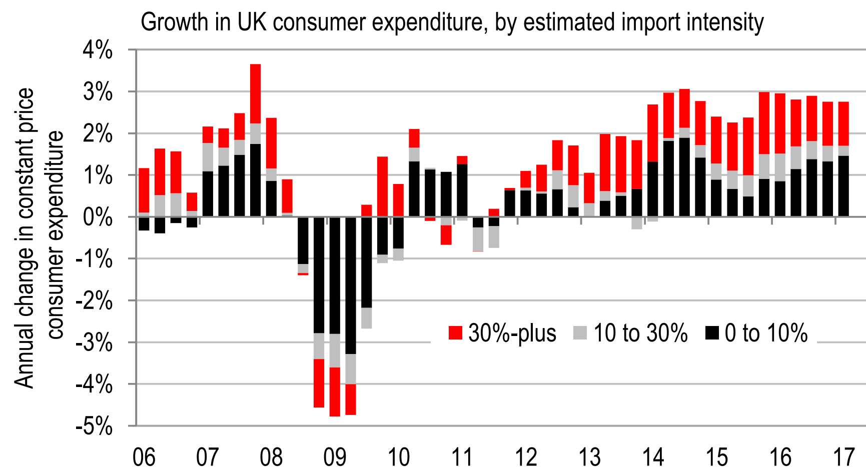
direct import intensity of more than 30% accounted for just 21% of spending. But this latter category still proved the main driver of headline consumer expenditure growth through to Q1-17, providing roughly half of the reported growth, while the domestically-focussed 0 to 10% category provided approximately 45% of the growth in spending.

On a micro view, spending upon new cars, clothing and furniture – which all fall within this 30%-plus import intensity category – appear to have made an unusually strong contribution to real terms consumption growth during this period. But from a macro perspective, the deflation recorded in this category during 2014-16 appears to have been critical in boosting the reported growth rates of the headline consumer expenditure data.

Flattering to deceive?

We believe that Charts 45 and 46 neatly illustrate the importance of price trends, rather than any volatility within nominal spending, to the reported shifts within the different categories of the consumer expenditure data. In particular, previously deflationary trends within the most import-intensive areas of consumer expenditure appear particularly important to the perception of a major acceleration of headline (real terms) spending growth from 2012 onwards (see Chart 47), even while expenditure growth on a nominal basis remained largely stable (Chart 48).

Chart 47: In constant price terms, consumption accelerated progressively during 2012-14…



Source: ONS, Thomson Reuters Datastream, Santander.
Note: Chart shows the annual change in constant price consumer expenditure, with a breakdown of this growth by estimated direct import intensity.

Nominal world offers real reassurance

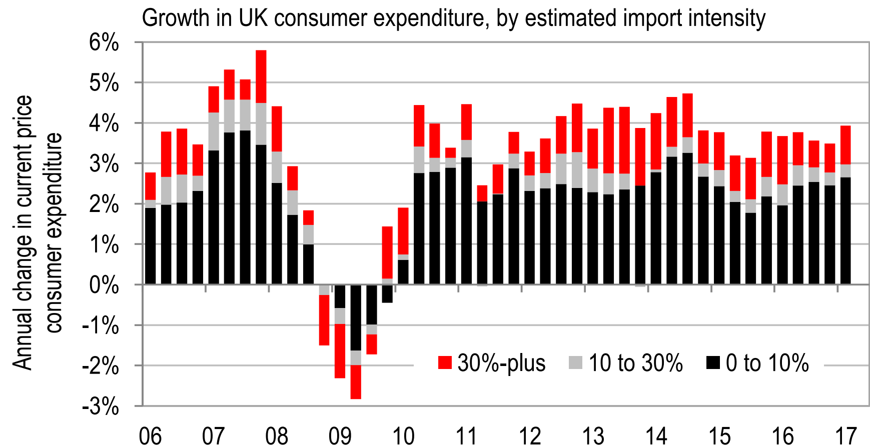
Interestingly, while the growth rates seen in real terms consumer expenditure during 2015-16 typically eclipsed those recorded in the immediate period before the last recession (according to both the latest GDP estimates and the 'real time' data released in 2006-07), the annual growth in nominal consumer expenditure during recent years has failed to approach the levels recorded in 2006-07 (Chart 48).

Given the growth observed within employment in recent years, the improvements seen within credit availability and a reduced level of economic volatility – not least the decline in the headline rate of unemployment at 40-year lows – we believe that commentary around 'excessive' UK consumption growth should be treated with caution.

Of course, news of a decline in the household sector savings ratio to a record low rate of just 1.7% in Q1-17 encouraged further scrutiny to fall upon the underlying health of the UK household sector's finances. But with a change in

the timing of pension entitlement payments possibly explaining a significant proportion of the decline in the household sector savings ratio , we believe that the series shown in Chart 49 – relating to wage & salary growth and total hours worked within the economy – offer greater reassurance around the outlook for nominal consumer expenditure growth. Although the weakness of productivity and average earnings growth has seen a wedge develop between the annual growth rates of total hours worked and wage & salary income, we believe that the current conditions across the UK labour market remain consistent with nominal consumer spending growth of roughly 4% per annum.

Chart 48: …but in nominal terms, consumption growth has moved sideways

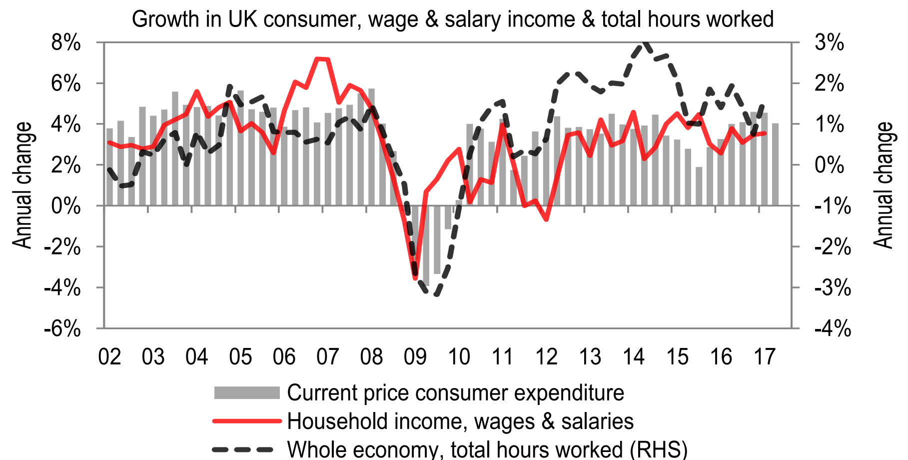


Source: ONS, Thomson Reuters Datastream, Santander.
Note: Chart shows the annual change in constant price consumer expenditure, with a breakdown of this growth by estimated direct import intensity.

A potential narrative for a consumer recovery

Nevertheless, with investors still likely to concentrate upon real terms measures of expenditure, the prospects for a shift in sentiment around the UK consumer likely rests in the first instance with a decline in imported price pressures. We believe that the available evidence supports this prospect, with Figure 50 illustrating the inflation rate from the 30%-plus import intensity category of expenditure - calculated from the monthly CPI data - as well as a range of inflation rates as implied by different output price survey indicators.

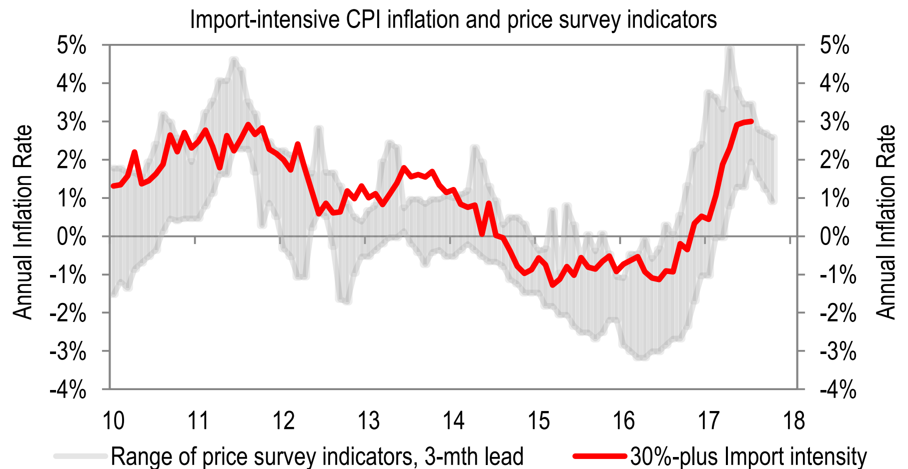
Chart 49: Nominal indicators of consumer spending and income offer a degree of reassurance



Source: ONS, Thomson Reuters Datastream, Santander.
Note: Chart shows the annual rate of change of current price consumer expenditure, the wage & salary component of household sector income, and the total number of hours worked in the economy.

These relate to the domestic manufacturers' price and imported finished goods price series from the Bank of England Agents' survey, the expected price on domestic orders series from the monthly CBI Industrial Trends survey, as well as the input and output price series from the UK manufacturing PMI survey. The survey data have been transformed so that each series possesses the same mean and variance as the calculated 30%-plus CPI inflation rate (measured between January 2005 and December 2014), in order to allow an easy comparison of the implied inflation rates. Although the recent weakness of the sterling is unlikely to be fully reflected within the survey data, we believe that imported price pressures will likely peak during the final months of this year, and work to support a critical area of the headline, real terms consumer expenditure data in turn.

Chart 50: A range of survey data suggest imported inflation could be approaching a peak



Source: ONS, Bank of England, CBI, Markit PMI, Thomson Reuters Datastream, Santander.
Note: Chart shows a calculated CPI annual inflation rate for those areas of consumer expenditure with an estimated direct import intensity of more than 30%, and a range of inflation rates implied by output price survey data. See text for a full explanation.

As such, we argue that concerns around a 'boom and bust' scenario developing within UK consumer expenditure are misplaced, and – even allowing for the uncertainties around the Article 50 process – we see critical areas of differentiation between the current outlook for nominal consumer spending, and those conditions which developed during the 2008-09 recession. Overall, we continue to look for headline GDP growth of roughly 1.5% to be recorded for 2017, and expect real terms consumer spending growth to rise back towards an annualised 1.5% to 1.8% annualised pace in 2018, helped by a deceleration of imported price pressures during the early months of next year.

UK Rates Strategy: Muddling along remains most likely for now

Adam Dent
(+44) 207 756 6223

- **The last month saw low volatility, a continuation of existing themes and little conviction in the UK rates market.**
- **Our main scenario is that this ambiguous state continues, allowing the UK to follow other rates higher in coming weeks.**
- **However, the unpredictable Brexit process has risks to either side; we discuss two alternative narratives and potential early indicators**

What did you miss from the beach? A classic August

Rates have been quantitatively quiet this August: the daily realized volatility of 10y GBP swaps over the month was just 2.67bp, the lowest for the time of year since 2005 (when the 10y rate was ~4.6% rather than 1.1%, so relative volatility remains much higher than in a pre-crisis summer). That was just 70% of the 3.81bp daily vol prevailing over the last year, the lowest ratio since 2009 (August saw a higher daily volatility than for the trailing 12m in many recent years, notably the run of 2013, ’14 and ’15).

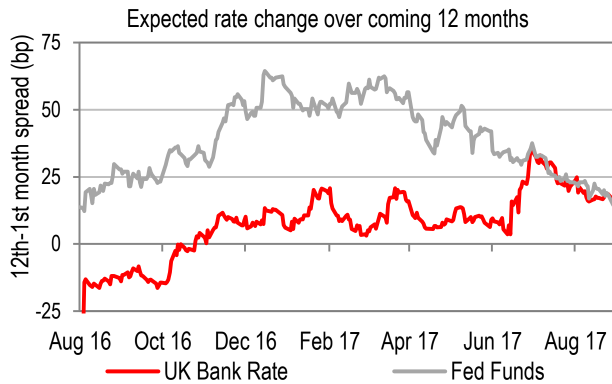
This was generally a good time to switch off from UK markets, with the trends and themes in place during July broadly staying in place:

- The surge in MPC hike expectations at the end of June continued to unwind, although more gradually after the 6-2 MPC vote confirmed that Chief Economist Haldane was not ready to follow-up his 22 June speech with action.
- Both gilt yields and swap spreads have been trending lower (wider), driven by the dovish shift in expectations for the BoE and other major central banks, on top of mounting global risk aversion.
- UK macro data has been roughly in line with, or even beating, (low) expectations. The consumer has remained the backbone of UK growth, but has been showing tentative signs of fatigue lately – see the UK Economics section above for more details.
- The fiscal situation looks similar to the OBR’s forecast for the year, reducing the likelihood that the Autumn Budget proves a major event or involves material revisions to the gilt issuance remit.
- The UK government has published a series of position papers on individual Brexit topics, although we found them to be exploratory rather than explicitly stating the UK’s specific goals or preferences – the EC’s President Junker and Chief Negotiator Bernier both expressed frustration with the papers’ ambiguity, especially with regard to the financial settlement.
- Gilt supply has been thin over the summer, but is about to pick up with a 50y syndication in the week of 4 September (we estimate at least £23.7mn of supply DV01 over the month). Supply will be light in the final quarter of this year, thanks to a lack of ultras.
- On the other side of supply/demand flows, we are in the midst of £26bn of gilt redemptions to investors followed by £11bn of related APF reinvestments from 4-20 September (likely to absorb circa £11mn of DV01 from the market) plus £4.3bn of coupons (-£2.5mn DV01).

The 10y CTD (4Q 27s) gilt’s yield closed a touch below 1.0% on Tuesday, not far from its fleeting YTD lows before June’s MPC meeting (Chart 52). That spell aside, yields are at their lowest since the start of last October, before trade-weighted sterling’s 5% depreciation and the ensuing boost to inflation breakevens and yields.

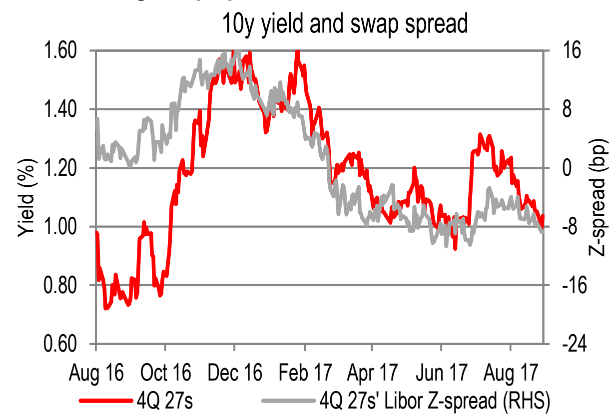
Gilt spreads look even more extreme, materially wider even than last summer when the BoE's surprisingly large and immediate QE extension was having its peak effect and yields were even lower than now.

Chart 51: Fed Funds and Bank Rate pricing have both declined since June, converging at just ⅔ of a hike over the next year



Source: ICAP, CBT, Santander.

Chart 52: Yields and spreads have returned to levels from May-June, leaving swap spreads much wider than last summer



Source: Bloomberg, Santander.

Central scenario: slow macro progress and a passive BoE allow for a grinding sell-off

- **BoE pricing stays around recent ranges, rate cuts off the table**
- **Outright rates drift gradually higher and steeper**
- **The pace and extent of the sell-off largely depends on the US**
- **5-10y gilt spreads relax back from their recent wides**
- **Long-end gilt spreads may widen a little from a lighter supply pace**
- **Inflation breakevens steepen as short-term upside tail risks fade**

Indicators:

- **Recent political / economic conditions prevail ('business as usual')**

We expect a more upbeat mood to take hold in global markets once the calm – and sparse news agenda– of the summer comes to an end. August has been quiet from a corporate issuance perspective, as well as gilt supply and market volatility, but we expect those floodgates to open once the US Labor Day holiday is over. We see heavier supply, greater market activity and news headlines – other than Korean tension and Brexit position papers for the market to focus on– to ease rate levels out of their own lull. The prospects of both ECB purchases and Fed reinvestments being tapered are likely to start to receive more attention, as discussed elsewhere in this publication, and contribute to a rates-bearish tone that should spill over to the UK.

There have been some potentially worrying indicators buried within recent UK releases –for instance, the consumption growth discussed in the UK Economics section– but the macro picture has generally been stable. The slow-moving Brexit negotiations look set to cast a shadow over sentiment in the UK for the rest of this year, which should help GBP rates outperform those elsewhere. However, markets, consumers and even businesses have shown a remarkable resilience to this source of enormous uncertainty over the last fourteen months and an open-mindedness to find the glass half full where possible. We believe it would take a major escalation of the process' difficulties to prevent rates from trending higher at all.

The BoE MPC's communications have repeatedly opined that sterling's weakness is due to fundamental factors that the central bank cannot offset. Depreciation versus the euro or a trade-weighted basket has resumed over the summer, and even Cable's June-July gains have largely unwound, but we do not expect this to provoke any response from the BoE other than recognition.

We expect the MPC to stand pat and monitor events, as long as the currency and growth are not collapsing. Spot inflation is set to reaccelerate later in the year, but its pressure on the MPC has likely peaked. The Committee seems keen for market pricing to allow it some room for manoeuvre, and the current profile of a hike in 2019 probably suits well. There could be another hawkish nudge if short rates were to rally much further, but we see a slightly higher threshold for the BoE to push back against a sell-off. That is, the Bank would be less likely to oppose the implicit support for sterling if markets were simply to put a little more weight on it joining a drift by the ECB and Fed towards the exit from exceptionally accommodative policy.

Once the initial excitement around the APF purchases subsides and the supply schedule returns to normal, anticipatory price discrimination between gilts that are in or out of the programme should fade, as in previous reinvestment periods. The ~20y region typically outperformed ahead of previous rounds, but not this time, suggesting that the gilt market may be becoming jaded towards APF price distortions and encouraging us to fade those we can detect. Please see our Gilt RV Focus from 29 August for more details and specific trade ideas.

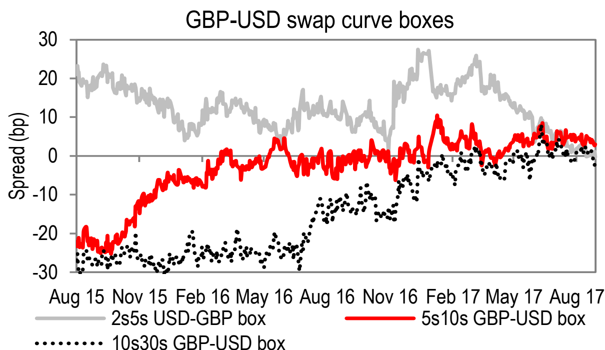
The pickup in sterling issuance is likely to put gilt spreads under tightening pressure from both sides: the direct weight of supply on gilts and swap-paying to hedge corporate issuance. With spreads so wide, risk reward in these conditions would favour tighteners, especially in the 5-10y region.

This 'muddling along' scenario is the central expectation represented in our forecasts. Rates would bear-steepen gently over the remainder of the year, although outperforming those of the US and eurozone. Unless this narrative is changed by one of the tail risks we explore below, we see the political and economic situation within the US as the key variable behind the timing and extent of the UK sell-off, via the outlook for the Fed and global growth.

The GBP and USD term structures have converged to a remarkable extent all across the curve, not just in short-run central bank expectations (Chart 53). As we expect improvements in the US macro/rates outlook, if any, to lead the way for those in the UK, we expect the USD curve to rebound more aggressively than GBP. We therefore continue to hold our 2s5s GBP flattener/USD steepener box recommendation from 9 June and see its current near-zero spread as a fairly firm floor to encourage new entrants.

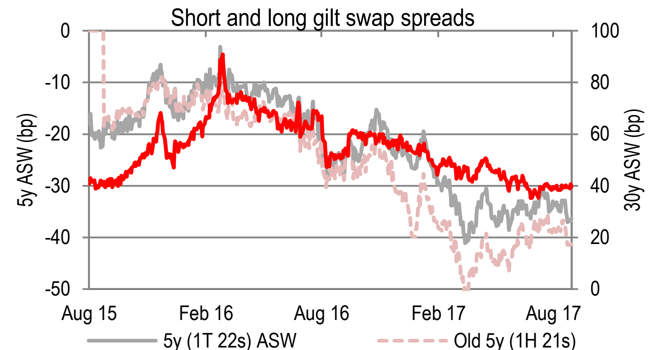
We will now outline what we see as the main risks to either side of this baseline and the warning signs we are watching out for.

Chart 53: UK and US interest rate slopes have converged all across the term structure, and we still see the 2s5s box as particularly prone to re-widening



Source: Bloomberg, Santander.

Chart 54: 30y gilt spreads have been stable recently, close to where they were two years ago, while short spreads have pushed on to extreme wides (even adjusting for roll-down)



Source: Bloomberg, Santander.

Alternative #1: Negotiations (or the Cabinet) break down

- **BoE hikes seen as even further off the table, cuts and QE in play**
- **Outright rates revisit last summer's lows**
- **Sub-10y gilt spreads ('safe havens') widen even further**
- **Long-end gilts incorporate more credit risk and tighten**
- **Currency depreciation boosts short-run inflation (and breakevens)**

Indicators:

- **'Friendly fire' briefings within the UK government**
- **More vocal frustration from the EU27, e.g. at their October summit**
- **Ministerial resignations**
- **High-profile business relocation / disinvestment announcements**

The Brexit negotiations may be going frustratingly slowly for the EC's leaders, businesses and trading timescales, but there does appear to be some progress. The UK's position papers and briefings have shown hints of increasing pragmatism; for instance, accepting that the ECJ could continue to have some relevance to the UK and a transition/implementation period that closely resembles the status quo. Our central case assumes this gradual, if unspectacular, progress is maintained.

"*We need to know their position and then I can be flexible*"

"*At the current state of progress we are quite far from being able to say that sufficient progress has taken place, sufficient for me to be able to recommend to the European Council that it engage in discussions on the future relationship.*"

– Michael Barnier

The EC's briefings have voiced mounting frustration that the UK has yet to unambiguously state what it wants on key topics, and that theme was maintained at the press conference concluding the latest round of talks on 31 August. This is hardly surprising given the reported variety of views within the UK Cabinet, let alone Parliament or the devolved administrations. Ministers have begun to present a more united front in recent weeks, such as Chancellor Hammond and Trade Secretary Fox's joint article in The Sunday Times (13 August), and its position papers showed signs of flexibility, if not clarity, on topics such as the ECJ. But the UK's attempts at pragmatism appear to have much to go to reach the EC's expectations.

An escalation of hostilities within the government cannot be ruled out. Even a low-key deadlock could have much the same effect in terms of Brexit if the Cabinet is unable to agree on specific and detailed positions the EC is calling for. It will be hard for PM May to force discipline and decisions on her colleagues, with her authority diminished by the General Election result.

If the government chooses, or needs to, they could perhaps maintain the current, indecisive approach to Brexit until the end of the year – at the cost of time and flexibility further down the line. But we believe "constructive ambiguity" will be extremely hard to maintain into 2018, with the clock ticking ever louder, so the crunch point cannot be delayed for much longer.

If the UK government reaches a clear impasse, external or internal, it would be hard for markets to continue giving the UK the benefit of the doubt. Expectations of additional BoE support would come back in play, even if the MPC does not actively encourage them: the further cut in Bank Rate the MPC asserted as a possibility last autumn and/or another extension of QE.

We would expect the prospect of further QE and traditional safe-haven attitudes to outweigh fears of higher gilt issuance and to drive gilt spreads out to 10y even wider, at least to begin with. Although tax receipts have consistently disappointed government forecasts for years, the exceptionally low level of unemployment and fiscal progress largely as-planned so far this year make for a good starting point. The new Chancellor has appeared enthusiastic to maintain

fiscal discipline, and the market is likely to be incredulous about projections of dramatic budgetary deterioration after the failure of the worst “Project Fear” forecasts to materialize in the wake of the Brexit vote so far.

The longer end is much more vulnerable to speculation around credit rating downgrades and long-term impairments to growth and government revenue. 30y gilt ASW, now at around 40bp, spiked above 90bp barely 18 months ago (Chart 54). It would likely take a sustained run of bad news for that peak to come back into sight, but a swift return to the 60bp seen last autumn (against a backdrop of major gilt QE) is very plausible.

The market moves we predict in this scenario are somewhat different to those that accompanied last September-October’s 8% collapse in trade-weighted sterling, even though that was also caused by a bout of market panic around Brexit. Now the initial shock has passed, we would expect a more traditional risk-off, monetary policy expectation-based response.

Alternative #2: A Brexit breakthrough boosts sentiment

- **BoE hikes priced more aggressively over the next two years**
- **Outright rates revisit or even break February's peaks**
- **Front-end gilt spreads tighten in a yield-grab / risk-on move …**
- **… that also widens long-end gilt spreads a little further**
- **A rebound in sterling quells imported inflationary pressures**

Indicators:

- **A successful reshuffle improves Cabinet discipline and unity**
- **A warmer tone to Barnier/Junker's commentary on the negotiations**
- **UK concessions around the financial settlement with the EU**
- **A coordinated, cross-bench campaign for a 'softer Brexit' solidifies**

There are tail risks on both sides of the process. The risk of failure has been in focus recently, but this could just be lowering the threshold for a positive surprise. Incremental behind-the-scenes progress could reach a tipping point and suddenly propel a quantum leap forwards in their public presentation; the EU became famed for 11th hour decision-making during the sovereign debt crisis, and similar timetabling may prove to be the case in this process.

The European Council meeting on 19-20 October is seen as a key date, with the potential to authorize the EC negotiating team to bring the future (trade) relationship into scope, as the UK side has been urging since before talks even began. Two rounds of talks are scheduled before then, and sufficient concessions to make a breakthrough by then are not impossible.

The EC is demanding a clearer stance from the UK to make progress, and conflicts within the UK government may be hindering that clarification. A renewal of PM May’s authority may be required to overcome such obstacles, so developments on this front are worth careful attention: a strong performance at the Conservative party conference or an effective Cabinet reshuffle would be potential examples. A new PM could be another way to renew momentum, but we see this as extremely unlikely in the short run.

If unexpected progress is made, or other developments were to materially improve the outlook for the UK economy, there is of course huge scope for market variables to rebound on a surge in macro confidence. The gradual bear-steepening of our central scenario could accelerate considerably, and the UK could give up some of its ample outperformance of USD and EUR rates over the last year. USTs currently offer a 1.10% yield spread over gilts, but this was as

tight as 0.45% just last October. 10y gilts also outperformed Bunds by 50bp since then. We would see the extreme richness of 5-10y gilt spreads as notably hard to justify in a less structurally risky environment.

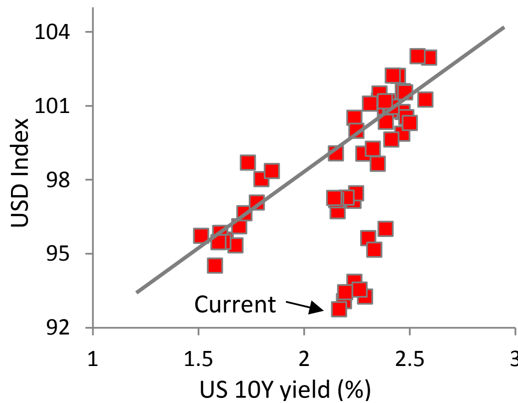
The (round trip) shift in market expectations for the MPC since June shows how sharply short rates can react just to talk. If the paralyzing effect of Brexit uncertainty looked to be lifting, we could see an even larger return to a hawkish outlook – especially if this was accompanied by improvements in global sentiment that also push Fed and ECB QE tightening up the agenda.

We do not see a good round of UK macro data (output, PMIs, wages, etc) as having the potential to move the market towards this upbeat alternative scenario on its own. Inflation is already widely forecast to reaccelerate later this year, individual months of good news can be written off as a blip not a trend, and the recent trend in growth rates would need a very big boost to change the narrative. While Brexit remains such a huge question, day-to-day macro data is doomed to remain marginal. Politics should continue to trump fundamentals in the UK for a while longer.

G10 FX Outlook

Stuart Bennett
(+44) 20 7756 4136

Chart 55: Risk key as yields hint at a USD oversell



Weekly data over the last year
Source: Bloomberg, Santander

USD – The new euro

The USD may remain vulnerable over the coming month, although we feel that its recent sell-off may have been overdone and factors could emerge to stabilise the currency. Domestic political uncertainty/jitters, and a reduced chance of a near-term Fed rate hike have dragged the USD lower. However, the US economy remains robust, and we still expect the FOMC to move to a less accommodative policy in Q4-17.

Political risks, rather than economic fundamentals, have remained a key driver of the USD over the last month, as they were a main driver of the EUR in the early part of the year.

The threat of conflict with North Korea has boosted demand for 'safety' trades. In the past, low risk appetite might have supported the USD in its role as a safe haven, but President Trump's political difficulties at home have made the market more willing to seek protection in the yen and euro.

The US government's inability to pass key legislation continues to feed doubts that it will be able to pass tax changes and boost stimulus measures. Such sentiment has kept US yields under pressure and, therefore, has also undermined the attractiveness of holding the USD.

A cheap USD may still be justified by the market's changing view with regard to possible US rate hikes in 2017. The Minutes of the July meeting showed that a majority of Fed members are confident inflation will gradually rise to the 2% target in the medium term. However, 'many' saw the 'likelihood' that inflation may remain below that level for longer than currently expected.

As such, the interest rate market is now pricing in only a 33% chance of a US rate hike by year-end. Such a view has also been fuelled by July CPI data, which showed headline CPI at 1.7%YoY, up from 1.6% in June, but lower than expected.

Table 5: G10 FX forecasts

	Q4 17	Q1 18	Q2 18	Q3 18	Q4 18
EUR-USD	1.14	1.15	1.17	1.18	1.20
GBP-USD	1.26	1.26	1.26	1.25	1.25
GBP-EUR	1.11	1.10	1.08	1.06	1.04
EUR-GBP	0.90	0.91	0.93	0.94	0.96
USD-JPY	114	116	118	119	120
EUR-JPY	130	133	138	140	144
EUR-CHF	1.12	1.14	1.14	1.16	1.20
USD-CHF	0.98	0.99	0.97	0.98	1.00
EUR-SEK	9.5	9.4	9.3	9.1	9.0
EUR-NOK	9.0	8.9	8.8	8.8	8.6
USD-CAD	1.25	1.25	1.24	1.24	1.22
AUD-USD	0.73	0.72	0.73	0.73	0.75
NZD-USD	0.66	0.67	0.68	0.69	0.70

Source: Bloomberg, Santander

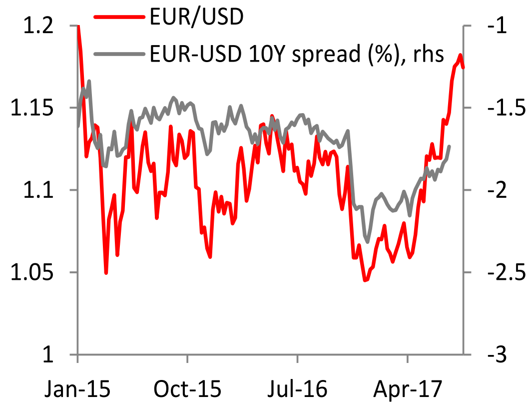
Admittedly, the correlation between the USD and US 10Y has fallen recently, as risk has become a more important factor for the USD. However, year-to-date the correlation is still positive (0.6) and suggests that the USD index is around 3% too cheap, given current yields.

However, 'slower' inflation and central bank 'dovishness' should only remain a persistent USD negative if they are confined to the US and Fed, respectively. It is possible that CPI sluggishness could spill over to Europe and other developed economies and encourage their central banks to delay any potential removal of monetary stimulus, which would tend to weigh on their currencies and boost/support the USD, if only by default.

Hence, if the FX market focuses on global 'slowflation', the USD should find support from expectations that GDP growth should outperform its peers and by the unwinding of short USD positions.

The consensus expects the US economy to grow 2.1% this year, and 2.3% in 2018, still exceeding Euro zone activity. Indeed, robust Euro zone growth may already have been priced in by the EUR/USD's recent gains, implying it will require upward revisions to justify further USD losses against the single currency.

Chart 56: EUR/USD has strayed into overbought territory, given yields and spreads



Source: Bloomberg, Santander

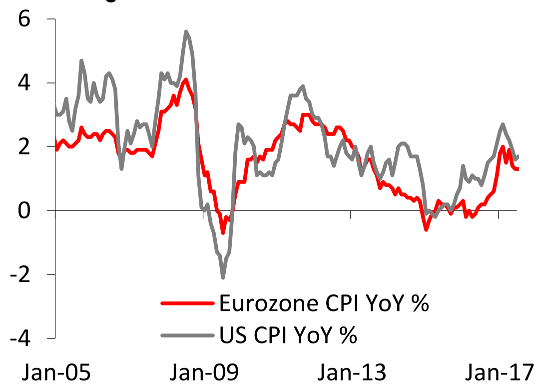
EUR – Too strong, too soon?

We have long been positive about the EUR's potential performance in 2017 and 2018. However, over the last couple of months the actual gain in EUR/USD has surpassed our forecasts. Indeed, since the publication of our 'FX Compass' on 23 August, the pair has moved higher, breaking above 1.2000 –for the first time since January 2015– on 29 August.

Many of the factors that we viewed as EUR positive at the start of the year, have occurred, or are still expected to occur. The Euro zone economy has recovered, and political risks in the Euro zone have diminished. Hence, we still expect the ECB to withdraw some of its monetary accommodation from the start of 2018.

Whilst these factors were likely to be EUR positive, the pace of EUR/USD's appreciation over the last few months owes as much, if not more, to the market's adoption of a very negative stance on the USD. The political risks that weighed on the EUR at the start of the year have now dragged the USD lower, as the market has become increasingly concerned about the effectiveness of the US administration.

Chart 57: Developed market inflation rates tend to follow each other. What is bad for the USD today could weigh on the EUR tomorrow

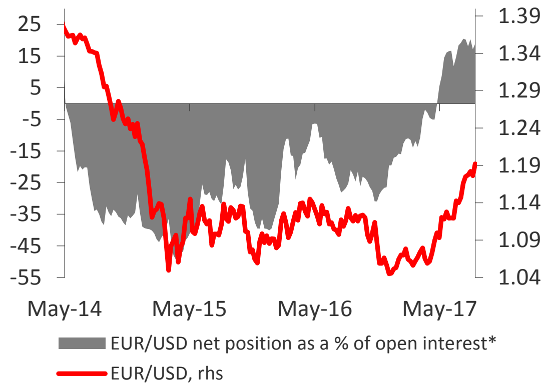


Source: Bloomberg, Santander

As the EUR can testify, such political concerns can have a persistent negative effect on a currency and allow it to decouple from 'fundamental' drivers. Hence, it may be difficult to envisage the EUR/USD reversing its recent gains and tumbling back to our year-end forecast of 1.1400.

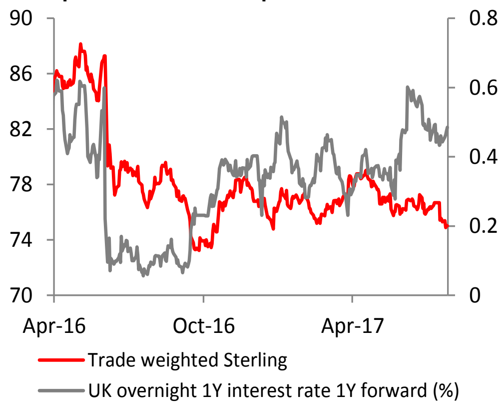
However, in fundamental terms, we still feel that EUR/USD has been overbought. The pair's gains appear premature, given that the US economy remains robust and the Fed is still likely to hike rates by the end of the year. Thus we still expect EUR/USD to give back some of the recent gains by the end of the 2017, before appreciating at a more steady rate in 2018, with a better risk environment and more sensibly priced USD implying

Chart 58: A change in risk and speculator sentiment has pulled EUR/USD higher



*Open Interest=total long and short contracts
Source: Bloomberg, Santander

Chart 59: A less hawkish MPC has pulled down rate hike expectations and the pound



Source: Bloomberg, Santander

EUR/USD is kept to around 1.20 by the end of 2018.

Overall, we still hold the view that a market that was too negative about the EUR earlier in 2017 and may now be over-compensating for that error, by now being too positive too quickly. The uptrend in EUR/USD started in May, after the French election, and has continued. The market has been relaxed about European political risks over the last few months. Whilst the German election on 24 September seems unlikely to worry the market too much, it may provide an excuse for EUR bulls to lock in profits before the end of Q3.

The EUR has gained as the 'political risk baton' has been handed to the USD and the US, with the focus on North Korean tension, US President Trump and doubts over the administration's ability to push ahead with its legislative programme. Consequently, the euro and yen have been boosted by safe haven demand.

The focus on US politics, along with lower US inflation and 'less hawkish' FOMC comments, has encouraged the market to reduce both the chances of a US rate hike in H2-17 and US yields. As such, the EUR-USD 10Y spread has moved in the EUR's favour.

However, we estimate that, based on the yield spread alone, EUR/USD has been overbought. Using data since the start of 2017, we estimate that, given the current spread, EUR/USD should be trading closer to 1.1400. Further, we still expect the Fed to hike rates in Q4-17 and see the US yield edging higher. These should also act as a brake on further EUR/USD gains in Q4.

Admittedly, we also expect the ECB to adopt a less-accommodative approach to its policy over the coming months and to signal that its QE programme will start to be tapered in 2018. This should be positive for the currency, but the EUR's recent gains may imply that most of this positive news has already been priced in. Hence, any 'overshooting' in the euro on confirmation of this, may be transient.

The Euro zone economy continues a robust recovery (+0.6% QoQ in Q2-17) but is still forecast to underperform the US in both 2017 and 2018. This 'growth gap' should rein in EUR gains. Plus, the small decline in inflation that has encouraged the market to assign less chance of another near-term US rate hike, may spill over to Europe. Headline Euro zone CPI was 1.3%YoY in July, and the Bank's rhetoric on inflation remains dovish.

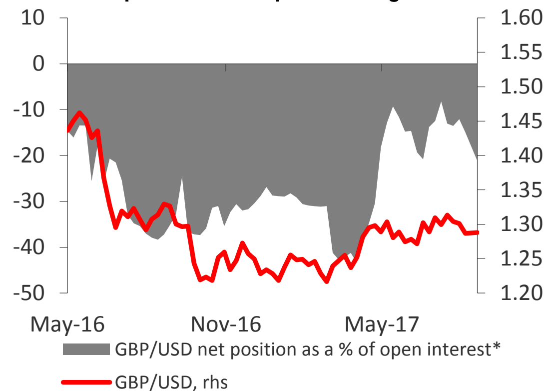
The risk, therefore, may be that 'slowflation' forces both the Fed and ECB to be more cautious about reversing stimulus. If this becomes apparent, perhaps following the ECB meeting on 7 September, the EUR should give back some, but not all of its recent gains. Indeed, speculators are now significantly net long EUR/USD, implying that the pair is vulnerable to an unwinding of these positions.

In addition, the account of the July ECB meeting indicated that ECB officials expressed concern over the risk of EUR strength. This suggests that the Bank may be reluctant to let the currency appreciate too quickly.

GBP – Hanging in

We retain a negative bias toward the pound in general, but in the very short term sterling may be more vulnerable against the USD rather than the EUR. In the medium-term, 'Brexit' uncertainty and what it may mean for the UK economy should continue to prevent any significant gains in sterling being sustained. The UK economy is still currently showing signs of vulnerability, which, together with the small dip in inflation in July, should keep the MPC on the cautious side and reluctant to hike rates.

Chart 60: Speculative scope to sell again?



*OI=Total long and short contracts
Source: Bloomberg, Santander

Hence, we are trimming the GBP/USD forecasts for 2018 and now see it hovering around 1.26; previously, we expected it to end the year at 1.30. Given that we continue to favour a steadier rise in EUR/USD to 1.2000 by year-end, this implies EUR/GBP reaching 0.96 by the end of 2018.

UK economic data has continued to offer sterling little by way of sustained support. Overall, the UK's economic surprise index still shows that economic data is continuing to come out weaker than expected. Whist we reiterate our view that the pound's weakness since late October 2015 has more than priced in the slowdown in the UK economy, the currency is still vulnerable to further undershooting if the data does not pick up.

Moreover, even if UK data stabilises, expectations that both the Euro zone and US should outperform the UK in H2-17 and 2018 may still weigh on sterling against the EUR and USD. The UK economy grew by 0.3% QoQ in Q2-17, compared with 0.6% for both the Euro zone and US. Softer UK activity data and a slight dip in inflation have also dented expectations that the BoE's MPC might be edging toward a hike. Following the MPC's 'hawkish' five to three June vote to keep rates on hold, the market priced in a 72% chance of a rate hike by the end of H1-18, but this has fallen to 47% after the Committee voted six to two to keep policy unchanged at the August meeting.

Our central scenario is that the MPC will not risk hiking rates until 2019. Hence, we will continue to recommend selling sterling into any rallies that are prompted by higher rate hike expectations. Given that we still believe that the Fed will hike US rates later this year and that the ECB will taper its QE in 2018, interest rate spreads should favour a softer GBP versus the USD and EUR.

Admittedly, the correlation between GBP/USD and GBP/EUR and their respective rate spreads has broken down over the last few months. However, we would interpret this as evidence that it has been global risk rather than fundamentals that have been the main FX driver and suspect that this may not remain the case. Plus, the longer-term correlation, over two years, between sterling and rate spreads remains very strong and currently indicates that the pound is overvalued against the USD and undervalued against the EUR.

Conversely, whilst the speculative market has cut its net short GBP/USD position over the last few months, the spot level, in our opinion, has not appreciated sufficiently in response. This implies that fast money accounts have ample scope to open fresh short positions if they become more concerned about Brexit/economic growth over the coming months.

Euro interest rate forecasts

Government Bond yield Forecasts

Bunds	Current	4Q17	1Q18	2Q18	3Q18	4Q18
ECB Depo	-0.40	-0.40	-0.40	-0.40	-0.40	-0.30
3m	-0.64	-0.70	-0.70	-0.65	-0.55	-0.40
2y	-0.73	-0.60	-0.45	-0.20	-0.05	0.15
5y	-0.33	-0.25	0.00	0.20	0.40	0.60
10y	0.38	0.55	0.80	1.00	1.15	1.25
30y	1.15	1.35	1.60	1.75	1.85	1.90

Swap rate forecasts

€ swaps	Current	4Q17	1Q18	2Q18	3Q18	4Q18
ECB Depo	-0.40	-0.40	-0.40	-0.40	-0.40	-0.30
3m	-0.33	-0.33	-0.31	-0.26	-0.18	-0.08
2y	-0.19	-0.05	0.05	0.20	0.30	0.50
5y	0.16	0.30	0.50	0.65	0.80	0.95
10y	0.80	1.00	1.20	1.40	1.50	1.60
30y	1.49	1.70	1.90	2.05	2.10	2.15

US interest rate forecasts

Government Bond yield Forecasts

USTs	Current	4Q17	1Q18	2Q18	3Q18	4Q18
FOMC (mid)	1.125	1.375	1.375	1.625	1.875	2.125
3m	0.99	1.20	1.35	1.60	1.90	2.15
2y	1.32	1.65	1.90	2.15	2.35	2.50
5y	1.69	2.00	2.20	2.45	2.70	2.90
10y	2.12	2.35	2.55	2.80	3.05	3.25
30y	2.73	2.90	3.00	3.15	3.30	3.45

Swap rate forecasts

$ swaps	Current	4Q17	1Q18	2Q18	3Q18	4Q18
FOMC (mid)	1.125	1.375	1.375	1.625	1.875	2.125
3m	1.32	1.50	1.65	1.85	2.15	2.40
2y	1.53	1.85	2.10	2.35	2.55	2.70
5y	1.76	2.05	2.25	2.50	2.75	2.95
10y	2.07	2.30	2.50	2.75	3.00	3.20
30y	2.39	2.60	2.70	2.90	3.05	3.20

UK Interest rate forecasts

Government Bond yield Forecasts

Gilts	Current	4Q17	1Q18	2Q18	3Q18	4Q18
MPC	0.25	0.25	0.25	0.25	0.25	0.25
3m	0.20	0.15	0.20	0.12	0.17	0.20
2y	0.18	0.25	0.30	0.10	0.20	0.25
5y	0.45	0.60	0.70	0.40	0.50	0.60
10y	1.05	1.25	1.50	1.25	1.40	1.60
30y	1.71	1.90	2.20	1.80	1.90	2.20

Swap rate forecasts

£ swaps	Current	4Q17	1Q18	2Q18	3Q18	4Q18
MPC	0.25	0.25	0.25	0.25	0.25	0.25
3m	0.28	0.30	0.35	0.27	0.27	0.30
2y	0.55	0.60	0.60	0.55	0.60	0.65
5y	0.79	0.85	0.95	0.75	0.80	0.80
10y	1.14	1.30	1.50	1.35	1.50	1.65
30y	1.45	1.65	1.95	1.40	1.50	1.90

FX forecasts

	Current	4Q17	1Q18	2Q18	3Q18	4Q18
EUR-USD	1.194	1.14	1.15	1.17	1.18	1.20
EUR-GBP	0.920	0.90	0.91	0.93	0.94	0.96
GBP-USD	1.200	1.26	1.26	1.26	1.25	1.25
USD-JPY	109.7	114	116.0	118.0	119	120
EUR-JPY	131.0	130	133.4	138.1	140	144

	Current	4Q17	1Q18	2Q18	3Q18	4Q18
NZD-USD	0.719	0.66	0.67	0.68	0.69	0.70
USD-CAD	1.237	1.25	1.25	1.24	1.24	1.22
AUD-USD	0.799	0.73	0.72	0.73	0.73	0.75
EUR-CHF	1.143	1.12	1.14	1.14	1.16	1.20
EUR-SEK	9.48	9.5	9.40	9.30	9.1	9.0
EUR-NOK	9.25	9.0	8.90	8.80	8.8	8.6

IMPORTANT DISCLOSURES

ANALYST CERTIFICATION:

The views expressed in this report accurately reflect the personal views of the undersigned analyst(s). In addition, the undersigned analyst(s) has not and will not receive any compensation for providing a specific recommendation or view in this report: **Antonio Villarroya, Luca Jellinek, José María Fernández, Antonio Espasa, Laura Velasco, Stuart Bennett, Adam Dent** and **Stuart Green.**

The analysts referenced in connection with the section for which he or she is responsible may have received or will receive compensation based upon, among other factors, the overall profitability of the Santander group, including profits derived from investment banking activities.

G-10 Rates, Macro & FX Strategy

Antonio Villarroya	Head of Macro & Strategy Research	antvillarroya@gruposantander.com	(+34) 91 257-2244
Luca Jellinek	Head of Rates and FX Strategy	luca.jellinek@santandergcb.com	(+44) 20 7756 4111
José María Fernández	Rates Strategy	josemariafernandezl@gruposantander.com	(+34) 91 257-2244
Edgar da Silva	Rates Strategy	efda@gruposantander.com	(+34) 91 257-2244
Stuart Green	UK Economics	stuart.green@santandergcb.com	(+44) 20 7756 6170
Adam Dent	UK Rates Strategy	adam.dent@santandergcb.com	(+44) 20 7756 6223
Stuart Bennett	G10 FX Strategy	stuart.bennett@santandergcb.com	(+44) 20 7756 4136
Michael Flisher	G10 FX Strategy	michael.flisher@santandergcb.com	(+44) 20 7756 5799
Antonio Espasa	Chief Economist	aespasa@gruposantander.com	(+34) 91 289 3313
Laura Velasco	G10 Economics	laura.velasco@gruposantander.com	(+34) 91 175 2289
Beatriz Tejero García	G10 Economics	beatriz.tejero@gruposantander.com	(+34) 91 257 2176

EXPLANATION OF THE RECOMMENDATION SYSTEM

DIRECTIONAL RECOMMENDATIONS IN BONDS		DIRECTIONAL RECOMMENDATIONS IN SWAPS	
	Definition		**Definition**
Long / Buy	Buy the bond for an expected average return of at least 10bp in 3 months (decline in the yield rate), assuming a directional risk.	**Receive fixed rate**	Enter a swap receiving the fixed rate for an expected average return of at least 10bp in 3 months (decline in the swap rate), assuming a directional risk.
Short / Sell	Sell the bond for an expected average return of at least 10bp in 3 months (increase in the yield rate), assuming a directional risk.	**Pay fixed rate**	Enter a swap paying the fixed rate for an expected average return of at least 10bp in 3 months (increase in the swap rate), assuming a directional risk.

RELATIVE VALUE RECOMMENDATIONS	
	Definition
Long a spread / Play steepeners	Enter a long position in a given instrument vs a short position in another instrument (with a longer maturity for steepeners) for an expected average return of at least 5bp in 3 months (increase in the spread between both rates).
Short a spread / Play flatteners	Enter a long position in a given instrument vs a short position in another instrument (with a shorter maturity for flatteners) for an expected average return of at least 5bp in 3 months (decline in the spread between both rates).

FX RECOMMENDATIONS	
	Definition
Long / Buy	Appreciation of a given currency with an expected return of at least 5% in 3 months.
Short / Sell	Depreciation of a given currency with an expected return of at least 5% in 3 months.

NOTE: Given the recent volatility seen in the financial markets, the recommendation definitions are only indicative until further notice.
We generally review our Rates/FX recommendations monthly, in our regular Interest & Exchange and FX Compass publications, and when market events/moves so warrant.

Comprehensive disclosures for all G-10 Rates, Macro & FX Strategy/research produced by Banco Santander, S.A. can be found on our website.

IMPORTANT DISCLOSURES

This report has been prepared by Banco Santander, S.A. and is provided for information purposes only. Banco Santander, S.A. is registered in Spain and is authorised and regulated by Banco de España, Spain.

This report is issued in the United States by Santander Investment Securities Inc. ("SIS"), in Spain by Banco Santander, S.A., under the supervision of the CNMV and in the United Kingdom by Banco Santander, S.A., London Branch ("Santander London"). SIS is registered in the United States and is a member of FINRA. Santander London is registered in the United Kingdom (with FRN 136261, Company No. FC004459 and Branch No. BR001085), and subject to limited regulation by the UK's Financial Conduct Authority ("FCA") and Prudential Regulation Authority ("PRA"). SIS, Banco Santander, S.A. and Santander London are members of Santander Group. A list of authorised legal entities within Santander Group is available upon request.

This material constitutes "investment research" for the purposes of the Markets in Financial Instruments Directive and as such contains an objective or independent explanation of the matters contained in the material. Any recommendations contained in this document must not be relied upon as investment advice based on the recipient's personal circumstances. The information and opinions contained in this report have been obtained from, or are based on, public sources believed to be reliable, but no representation or warranty, express or implied, is made that such information is accurate, complete or up to date and it should not be relied upon as such. Furthermore, this report does not constitute a prospectus or other offering document or an offer or solicitation to buy or sell any securities or other investment. Information and opinions contained in the report are published for the assistance of recipients, but are not to be relied upon as authoritative or taken in substitution for the exercise of judgement by any recipient, are subject to change without notice and not intended to provide the sole basis of any evaluation of the instruments discussed herein.

Any reference to past performance should not be taken as an indication of future performance. This report is for the use of intended recipients only and may not be reproduced (in whole or in part) or delivered or transmitted to any other person without the prior written consent of Banco Santander, S.A..

Investors should seek financial advice regarding the appropriateness of investing in financial instruments and implementing investment strategies discussed or recommended in this report and should understand that statements regarding future prospects may not be realised. Any decision to purchase or subscribe for securities in any offering must be based solely on existing public information on such security or the information in the prospectus or other offering document issued in connection with such offering, and not on this report.

The material in this research report is general information intended for recipients who understand the risks associated with investment. It does not take into account whether an investment, course of action, or associated risks are suitable for the recipient. Furthermore, this document is intended to be used by market professionals (eligible counterparties and professional clients but not retail clients). Retail clients must not rely on this document.

To the fullest extent permitted by law, no Santander group company accepts any liability whatsoever (including in negligence) for any direct or consequential loss arising from any use of or reliance on material contained in this report. All estimates and opinions included in this report are made as of the date of this report. Unless otherwise indicated in this report there is no intention to update this report.

Banco Santander, S.A. and its legal affiliates (trading as Santander and/or Santander Global Corporate Banking) may make a market in, or may, as principal or agent, buy or sell securities of the issuers mentioned in this report or derivatives thereon. Banco Santander, S.A. and its legal affiliates may have a financial interest in the issuers mentioned in this report, including a long or short position in their securities and/or options, futures or other derivative instruments based thereon, or vice versa.

Banco Santander, S.A. and its legal affiliates may receive or intend to seek compensation for investment banking services in the next three months from or in relation to an issuer mentioned in this report. Any issuer mentioned in this report may have been provided with sections of this report prior to its publication in order to verify its factual accuracy.

Banco Santander, S.A. and/or a company in the Santander group is a market maker or a liquidity provider for EUR/GBP, EUR/JPY and EUR/USD.

Banco Santander, S.A. and/or a company of the Santander group has been lead or co-lead manager over the previous 12 months in a publicly disclosed offer of or on financial instruments of the UK Debt Management Office.

ADDITIONAL INFORMATION

Banco Santander, S.A. or any of its affiliates, salespeople, traders and other professionals may provide oral or written market commentary or trading strategies to its clients that reflect opinions that are contrary to the opinions expressed herein. Furthermore, Banco Santander, S.A. or any of its affiliates' trading and investment businesses may make investment decisions that are inconsistent with the recommendations expressed herein.

No part of this report may be copied, conveyed, distributed or furnished to any person or entity in any country (or persons or entities in the same) in which its distribution is prohibited by law. Failure to comply with these restrictions may breach the laws of the relevant jurisdiction.

Investment research issued by Banco Santander, S.A. is prepared in accordance with the Santander group policies for managing conflicts of interest. In relation to the production of investment research, Banco Santander, S.A. and its affiliates have internal rules of conduct that contain, among other things, procedures to prevent conflicts of interest including Chinese Walls and, where appropriate, establishing specific restrictions on research activity. Information concerning the management of conflicts of interest and the internal rules of conduct are available on request from Banco Santander, S.A..

COUNTRY & REGION SPECIFIC DISCLOSURES

U.K. and European Economic Area (EEA): Unless specified to the contrary, issued and approved for distribution in the U.K. and the EEA by Banco Santander, S.A. Investment research issued by Banco Santander, S.A. has been prepared in accordance with Grupo Santander's policies for managing conflicts of interest arising as a result of publication and distribution of investment research. Many European regulators require that a firm establish, implement and maintain such a policy. This report has been issued in the U.K. only to persons of a kind described in Article 19 (5), 38, 47 and 49 of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (all such persons being referred to as "relevant persons"). This document must not be acted on or relied on by persons who are not relevant persons. Any investment or investment activity to which this document relates is only regarded as being provided to professional investors (or equivalent) in their home jurisdiction. **United States of America (US):** This report is being distributed to US persons by Santander Investment Securities Inc ("SIS") or by a subsidiary or affiliate of SIS that is not registered as a US broker dealer, to US major institutional investors only. Any US recipient of this report (other than a registered broker-dealer or a bank acting in a broker-dealer capacity) that would like to effect any transaction in any security or issuer discussed herein should contact and place orders in the United States with the company distributing the research, SIS at (212) 692-2550, which, without in any way limiting the foregoing, accepts responsibility (solely for purposes of and within the meaning of Rule 15a-6 under the US Securities Exchange Act of 1934) under this report and its dissemination in the United States. US recipients of this report should be advised that this research has been produced by a non-member affiliate of SIS and, therefore, by rule, not all disclosures required under NASD Rule 2711 apply. **Hong Kong (HK):** This report is being distributed in Hong Kong by a subsidiary or affiliate of Banco Santander, S.A. Hong Kong Branch, a branch of Banco Santander, S.A. whose head office is in Spain. The 1% ownership disclosure satisfies the requirements under Paragraph 16.5(a) of the Hong Kong Code of Conduct for persons licensed by or registered with the Securities and Futures Commission, HK. Banco Santander, S.A. Hong Kong Branch is regulated as a Registered Institution by the Hong Kong Monetary Authority for the conduct of Advising and Dealing in Securities (Regulated Activity Type 4 and 1 respectively) under the Securities and Futures Ordinance. The recipient of this material must not distribute it to any third party without the prior written consent of Banco Santander, S.A. **Japan (JP):** This report has been considered and distributed in Japan to Japanese-based investors by a subsidiary or affiliate of Banco Santander, S.A. - Tokyo Representative Office, not registered as a financial instruments firm in Japan, and to certain financial institutions defined by article 17-3, item 1 of the Financial Instruments and Exchange Law Enforcement Order. Some of the foreign securities stated in this report are not disclosed according to the Financial Instruments and Exchange Law of Japan. There is a risk that a loss may occur due to a change in the price of the shares in the case of share trading and that a loss may occur due to the exchange rate in the case of foreign share trading. **China (CH):** This report is being distributed in China by a subsidiary or affiliate of Banco Santander, S.A. Shanghai Branch ("Santander Shanghai"). Santander Shanghai or its affiliates may have a holding in any of the securities discussed in this report; for securities where the holding is greater than 1%, the specific holding is disclosed in the Important Disclosures section above.

For further country and region specific disclosures please refer to Banco Santander, S.A..

Local Offices

Madrid	**Lisbon**	**London**	**Milan**
Tel: 34-91-257-2035	Tel: 351-21-389-3400	Tel: 44-870-607-6000	Tel: 39-02-8542-09810
Fax: 34-91-257-0252	Fax: 351-21-387 0175	Fax: 44-20-7332-6909	Fax: 39-02-8606-71648
Brussels	**Paris**	**Frankfurt**	**Tokyo**
Tel: 32 2 286 5447	Tel: 33 15353 7000	Tel: 49 6959 67-6403	Tel: 813-5561-0591
Fax: 32 2 230 6724	Fax: 33 15353 7060	Fax: 49 6959 67-6407	Fax: 813-5561-0580
New York	**Bogota**	**Buenos Aires**	**Caracas**
Tel: 212-756-9160	Tel: 571-644-8008	Tel: 54114-341-1052	Tel: 582-401-4306
Fax: 212-407-4540	Fax: 571-592-0638	Fax: 54114-341-1226	Fax: 582-401-4219
Lima	**Mexico DF**	**Santiago de Chile**	**São Paulo**
Tel: 511-215-8133	Tel: 525-629-5040	Tel: 562-336-3300	Tel: 5511-3012-5721
Fax: 511-215-8161	Fax: 525-629-5846	Fax: 562-697-3869	Fax: 5511-3012-7368

Grupo Santander ©. 2017. All Rights Reserved.

Santander
GLOBAL CORPORATE BANKING

Dow Jones Sustainability Indexes
Member 2006/07

FTSE4Good Index Series